

**H.R. 1042—THE NET WORTH
AMENDMENT FOR CREDIT UNIONS ACT**

HEARING
BEFORE THE
SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
OF THE
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES
ONE HUNDRED NINTH CONGRESS
SECOND SESSION

APRIL 13, 2005

Printed for the use of the Committee on Financial Services

Serial No. 109-16



U.S. GOVERNMENT PRINTING OFFICE
22-765 PDF

WASHINGTON : 2005

For sale by the Superintendent of Documents, U.S. Government Printing Office
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H.R. 1042—THE NET WORTH AMENDMENT FOR CREDIT UNIONS ACT

Wednesday, April 13, 2005

**U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
*Washington, D.C.***

The subcommittee met, pursuant to call, at 2:28 p.m., in Room 2128, Rayburn House Office Building, Hon. Spencer Bachus [chairman of the subcommittee] presiding.

Present: Representatives Bachus, Feeney, Hensarling, Sanders, Sherman, Meeks, and Green.

Chairman BACHUS. [Presiding.] The committee will come to order.

Today we are here to have a hearing on H.R. 1042, the Net Worth Amendment for Credit Unions Act.

I am going to go ahead and depart with opening statements and move right to our panel because of the time.

At this time, Ms. Johnson, we will just hear from you, and we will go from you to Mr. Herz and then Mr. Reynolds.

So, welcome to the committee.

STATEMENT OF HON. JOANN JOHNSON, CHAIRMAN, NATIONAL CREDIT UNION ADMINISTRATION

Ms. JOHNSON. Chairman Bachus and Ranking Member Sanders and members of the subcommittee, I appreciate your invitation to appear here today to speak on behalf of the National Credit Union Administration to support the important legislation you have introduce: the Net Worth Amendment for Credit Unions Act.

NCUA anticipates that the Financial Accounting Standards Board will act in 2005 to lift the current deferral of the acquisition method of accounting for mergers by credit unions, thereby eliminating the pooling method and requiring the acquisition method beginning in 2006.

When this change to accounting rules is implemented, it will require that in a merger, net assets on a fair value basis of the merging credit union as a whole, rather than retained earnings, be carried over as acquired equity, a term not recognized by the Federal Credit Union Act.

This FASB policy has been in place since mid-2001 for most business combinations, and the delay by FASB in implementing it for credit unions has allowed all of us to explore how credit unions

could conform to the new financial reporting standards. H.R. 1042 is a good solution.

Without the changes to the Federal Credit Union Act proposed by H.R. 1042, only retained earnings of the continuing credit union will count as net worth after a merger.

This result would seriously reduce the post-merger net worth ratio of a federally insured credit union, because this ratio is the retained earnings of only the continuing credit union stated as a percentage of the combined assets of the two institutions.

A lower net worth ratio has adverse implications under the statutory Prompt Corrective Action regulation. This result will discourage voluntary mergers, and on occasion make NCUA-assisted mergers more difficult and costly to the National Credit Union Share Insurance Fund.

Without a remedy, an important NCUA tool for reducing costs and managing the fund in the public interest will be lost.

This agency, and the credit unions we serve, are grateful for the analysis and time you are devoting to this matter and for bringing us quickly to the point of advancing the narrow and specific changes to the Federal Credit Union Act needed to preserve credit union capital in mergers that take place after FASB fully implements its policy for credit unions.

FASB's proposed change to accounting rules, along with an amendment to the Federal Credit Union Act, that allows NCUA to recognize "any amounts that were previously retained earnings of any other credit union" will, I believe, produce results consistent with the goal of FASB and comparable to results achieved for other business combinations.

The result preserves the capital accumulated by both institutions and, importantly, is less likely to place the combined institution into a lower PCA category.

My written statement describes the consequences for federally insured credit unions, were they to fall into lower PCA categories as a result of a merger, that does not recognize the retained earnings of the merger credit union.

A merger normally has a necessary or beneficial impact, but it may cause adverse consequences if the retained earnings of the merged credit union are lost—an unexpected and undesirable consequence for credit unions, their members and NCUA.

The management and board of directors of the continuing credit union considering a merger will give pause when faced with this result, as will NCUA.

The number of mergers—around 300 a year—has been relatively constant for a number of years, so the significance of both the potential problem and the significance of the solution offered by H.R. 1042 is quite real.

If FASB's statement of financial accounting standard 141 had been applied to federally insured credit unions in 2004, without the statutory adjustment provided by H.R. 1042, some \$300 million in credit union capital might have been lost for PCA purposes.

The Net Worth Amendment for Credit Unions Act clearly and appropriately preserves the only source of hard earned credit union capital when mergers of institutions are accomplished: retained earnings.

Thank you, Mr. Chairman, Ranking Member Sanders and the many co-sponsors for introducing H.R. 1042, for holding this hearing today and acting to preserve the capital of federally insured credit union.

[The prepared statement of Hon. JoAnn Johnson can be found on page 66 in the appendix.]

Chairman BACHUS. Thank you.

Mr. Herz, we welcome you.

STATEMENT OF ROBERT HERZ, CHAIRMAN, FINANCIAL ACCOUNTING STANDARDS BOARD

Mr. HERZ. Thank you, Chairman Bachus, Ranking Member Sanders and all the members of the subcommittee.

I am Bob Herz, chairman of the Financial Accounting Standards Board, and I am very pleased to appear here today. And I want to thank you for inviting me to participate at an important and I think timely hearing.

I have brief prepared remarks and would respectfully request that the full text of my testimony and all supporting materials be entered into the public record.

Chairman BACHUS. Without objection.

Mr. HERZ. Thank you.

Chairman BACHUS. And that will be for all our panelists, if you have prepared remarks.

Mr. HERZ. The FSAB is an independent, private-sector organization. Our ability to conduct our work in a systematic, thorough and unbiased manner is fundamental to achieving our mission, that is, to establish and improve general-purpose standards of financial accounting and reporting for both public and private enterprises.

Those standards are essential to the growth and stability of the U.S. economy, because creditors, investors and other users of financial reports rely heavily on credible, transparent, comparable and unbiased financial information to make economic decisions.

And because the actions of the FASB affect so many organizations, our decision-making process must be open, it must be thorough, and it must be as objective as possible.

Therefore, our rules of procedure require an extensive and public due process.

That process involves public meetings, public roundtables, field visits to affected parties, liaison meetings with interested parties, consultation with many advisory councils, and exposure of our proposed standards to external scrutiny and public comment.

In June of 2001, after several years of extensive public due process, the FASB issued a standard to improve the accounting and financial reporting for business combinations.

That standard, supported by many users, auditors and preparers of financial reports, provides that all business combinations be accounted for by a signal method: the purchase method.

The standard thus eliminated an existing alternative method of accounting for business combinations, the so-called pooling-of-interest method.

But in developing the standard, the board decided to defer its effective date for combinations between credit unions and other mutual enterprises.

The board concluded that a deferral was appropriate so that we could consider further the need for additional interpretive guidance explaining such things as how the purchase method might be applied by those enterprises.

Since the issuance of the standard, the board has continued to specifically discuss combinations between mutual enterprises, including credit unions, at eight public board meetings.

In connection with those meetings, individual board members and staff sought input on the issue from many representatives of credit unions and other mutual enterprises at public and private meetings and at a number of conferences across the country.

The board has tentatively reaffirmed the conclusion reached in our 2001 standard on business combinations that unions between credit unions and other mutual enterprises should be accounted for as acquisitions of businesses under the purchase method, consistent with the accounting for such transactions applied by all other types of business enterprises, including all other depository and lending institutions.

In addition, the board has developed proposed changes to improve the procedures for applying the purchase method, which includes additional interpretive guidance to assist credit unions and other mutual enterprises in applying the purchase method.

The board plans to include these tentative decisions for mutual enterprises and credit unions, together with some other tentative decisions on applying the purchase method, in a proposal for public comment.

Right now we expect that proposal to be issued for comment by the end of June this year.

Following the comment period, the board will, at public meetings over a number of months, carefully consider the comments received and all other input from credit unions and other enterprises in response to the proposal.

As with virtually all of our projects, these public redeliberations will most likely result in a number of changes to clarify and hopefully improve the proposal.

And only after carefully evaluating the key issues raised and carefully considering the input received in response to a proposal will our board consider whether or not to issue a final standard.

We have reviewed the provisions of H.R. 1042, the Net Worth Amendment For Credit Unions Act. Consistent with our mission and expertise, we do not take positions on proposed legislation or other public policy initiatives, except in those limited circumstances when those initiatives would impair the mission and independence of the FASB.

However, we do have a couple of observations.

First, we would observe that the provisions of H.R. 1042 appear to revise the definition of net worth as defined under the Federal Credit Union Act.

The proposed revision of that definition appears to resolve a potential regulatory issue that many in the credit union industry have said if not resolved would have adverse consequences for mergers of credit unions.

Secondly, we also observe that the provisions of H.R. 1042 do not appear to establish or change general-purpose standards of financial accounting and reporting, i.e., what we are responsible for.

We therefore very much appreciate, Mr. Chairman, your leadership in addressing this important matter in such a thoughtful and appropriate way.

Thank you.

[The prepared statement of Robert H. Herz can be found on page 20 in the appendix.]

Chairman BACHUS. Thank you.

Mr. Reynolds?

STATEMENT OF GEORGE REYNOLDS, SENIOR DEPUTY COMMISSIONER, GEORGIA DEPARTMENT OF BANKING AND FINANCE, REPRESENTING THE NATIONAL ASSOCIATION OF STATE CREDIT UNION SUPERVISORS

Mr. REYNOLDS. Thank you, Chairman Bachus and members of the subcommittee.

I am George Reynolds, Senior Deputy Commissioner for the Georgia Department of Banking and Finance. I appear today on behalf of the National Association of State Credit Union Supervisors, NASCUS, the professional state credit union regulators association.

In addition to being a state regulator, I am a certified public accountant, allowing me to study and understand the financial standard board, FASB's recommendations and their impact on mutuals.

My testimony today is to urge your support of H.R. 1042, the Net Worth Amendment for Credit Unions Act. This act amends the Federal Credit Union Act to clarify the definition of net worth for purposes of corrective action.

While this bill is extremely brief, I cannot overemphasize the criticality of this change to the safety and soundness of credit unions.

The Financial Accounting Standards Board is making changes to accounting standards for business combinations between mutual enterprises, which includes credit unions.

The result of these changes is two-fold: First, the pooling-accounting method will no longer be an acceptable method of accounting for business combinations; second, purchase accounting will now be used almost exclusively for business combinations.

My brief time before the subcommittee does not permit a detailed explanation of purchase accounting versus pooling accounting. I do, however, want to outline the serious, unintended consequences of this change.

Without the proposed statutory amendment, a merger transaction between two credit unions would not allow the capital of the merging credit union to be added to the retained earnings of the surviving credit union. This will discourage mergers recommended by state regulators.

Mergers are a safety and soundness tool regulators use to protect funds deposited by American consumers and to preserve the National Credit Union Share Insurance Fund.

Our department and other state departments regularly use mergers to combine weak or troubled financial institutions with larger

and stronger financial institutions, providing a win-win for both American consumers and the insurance fund.

Without the ability to combine the capital of the two institutions, in addition to the assets and liabilities acquired on the balance sheet, there would be a serious disincentive to effect such mergers. This is particularly important in purchase accounting, which provides for reflecting assets and liabilities acquired at their fair market value.

Marking the balance sheet to market, while not being able to include acquired capital, is a recipe for capital dilution. After a merger, such credit unions might find themselves in a prompt corrective action, PCA, category which would result in unintended mandatory regulatory actions.

If a credit union could not be merged due to PCA concerns caused by the inability to add the capital of the merged credit union, then credit unions in weakened condition would be more likely to face liquidation or requests for NCUA financial assistance in merger transactions.

An increase in liquidations would cause greater reputation risk, a severe loss of confidence for the credit union industry, greater losses to the deposit insurance fund, and increased costs to the industry and ultimately to consumers.

Additionally, most credit unions have some deposits that exceed the deposit insurance limit. These members could face the prospect of losing these funds in a liquidation.

Stated simply, this is a recipe for disaster. I never want credit unions that I regulate in Georgia, or the credit unions in any other state, to be confronted with this possibility.

In addition to problem institutions, sound credit unions have sought merger partners in order to provide for greater efficiencies of scale, management succession and improved member services.

We have been in a period of industry consolidation in credit unions during the past several years. Without these changes, credit unions that might otherwise be operating in a safe fashion might not be able to execute optimal business decisions which would benefit the credit union and its members.

The impact of H.R. 1042 would be to revise the definition of net worth to include both the retained earnings of the surviving credit union and the capital of any other credit union with which the surviving credit union is combined.

This would permit capital to be added across in a merger transaction and would serve to augment the capital position of the surviving credit union. This makes sound business sense and increases the safety and soundness of the credit union industry.

In closing, this bill proactively addresses the safety and soundness concerns of state regulators.

Chairman Bachus, on behalf of NASCUS, please accept our appreciation for your foresight and steadfastness in your commitment to introduce H.R. 1042.

This concludes my remarks. NASCUS appreciates the opportunity to testify today. We welcome further participation and dialogue. And I will respond to any questions the subcommittee may have.

Thank you.

[The prepared statement of George A. Reynolds can be found on page 71 in the appendix.]

Chairman BACHUS. I thank you.

Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman.

This seems like a fairly straightforward matter, so I will be brief. Mr. Reynolds, you had some pretty strong language in your testimony, if I heard you correctly: "recipe for disaster" if we do not pass this, you "cannot overemphasize the criticality of this change."

So can you go into a little bit more detail as far as what you see what is going to happen in the state of Georgia if we do not pass this with respect to the safety and soundness of the credit unions that you help oversee, and ultimately what could happen to the members of credit unions in Georgia as far as the fees and services that are offered?

Mr. REYNOLDS. Well, Congressman, we have been very successful in using merger as a tool to resolve problem credit unions without cost to the taxpayer and without disruption of services to members.

I am concerned that without this change that the number of credit unions that are going to be willing to merge with troubled credit unions is going to be reduced significantly, that the credit unions that otherwise might be interested in acquiring or merging with a credit union to get their field of membership would have a serious disincentive without this change, because they could find themselves potentially in a PCA situation.

So I do think it is a very serious issue.

Mr. HENSARLING. Mr. Herz, just for a point of clarification, I think I heard you correctly, but is it your opinion that H.R. 1042 does not dictate any general accounting standards or undermines FASB's role? Is that what I think I heard you say?

Mr. HERZ. Yes. I mean, from our perspective—I am certainly not an expert in what constitutes appropriate regulatory capital or capital adequacy. That is up to the regulators. But this would, as I understand it, just affect the regulatory capital computation rather than prescribing different GAAP.

Mr. HENSARLING. Mr. Chairman, I think I have heard enough and I yield back.

Chairman BACHUS. Thank you, I appreciate your participation. I think you asked the right questions.

At this time I am going to recognize Mr. Sanders to not only—I am going to have five minutes for questions, but an additional time for an opening statement.

Mr. SANDERS. Well, thank you very much, Mr. Chairman. I will not take all of that time. I apologize for not being here earlier, but you know how it is sometimes on Capitol Hill.

So I want to welcome all of our guests.

And thank you, Mr. Chairman, for holding this important hearing.

And as you know, Mr. Chairman, I am pleased to be an original co-sponsor of your Net Worth Amendment for Credit Unions Act, and I applaud you for doing what you are doing.

This legislation I think, as we all know, is necessary to conform to new accounting practices for mergers of credit unions that the

Financial Accounting Standards Board is scheduled to put into effect early next year.

And I want to thank the National Association of Federal Credit Unions for bringing this issue to our attention, and I am glad that we could work together in crafting a bill with wide support.

What I would just like to do is ask a few questions of our guests, if I might, Mr. Chairman.

Let me start off with Chairwoman Johnson: My understanding is that NCUA has recently shared with some members a proposal to move to a risk-based PCA system for credit unions.

Is this amendment also part of that proposal? Or would that proposal, if enacted, eliminate the need for this amendment?

Ms. JOHNSON. Thank you, Congressman, for the question.

No, they are two separate issues. The risk-based capital is a separate proposal. Both of the issues we are talking about do deal with prompt, corrective action but from different standpoints, so they are totally separate.

Under the Federal Credit Union Act, there is only one way for insured credit unions to build capital, and that is through net worth. And a risk-based system would more accurately measure the correct levels of net worth based on a risk profile.

What we are talking about here today is actually just concerning the merger of credit unions and how the capital is accumulated.

Mr. SANDERS. Thank you very much.

If I could ask Mr. Herz a question—and I just wanted to be sure that the record is clear: Is it your understanding that this bill would not in any way legislate accounting standards?

Mr. HERZ. Yes.

Mr. SANDERS. Now, I like that man.

[Laughter.]

That man is going to go far in Washington. You will be very popular.

And, Mr. Herz, let me ask you another question: Do you have any update on when FASB will be issuing the proposed rule and/or when the rule will become effective? Has there been any consideration to delaying the effective date so that this issue can be addressed by Congress?

That will take more than one word, right?

Mr. HERZ. Yes.

We are due to issue the proposal, the exposure draft, the end of June. It will probably be out for comments for 90 to 100 days, that kind of period. We will probably hold some public roundtables.

After that we will get in comment letters. And then, depending on the input we get, we go into what is called redeliberation: We go through the issues again based upon all the comments.

Depending on how long that takes and what we hear, we may get out a final standard this year. It may take longer.

This project, the larger project of which this is part—by the way, we have been doing the mutual part of this with the Canadians. They have had a big interest in this subject as well.

And other parts of this are being done with the International Accounting Standards Board, whose standards are recognized in about 100 countries in the world.

So if any of you have been involved in international logistics, you understand that sometimes getting everybody to agree on things can take some time. But it is worth it.

If I had to hazard a guess—and this is just an absolute guess; it really depends on the input we get—I am not sure this will be effective at the beginning of January 2006. But I still support, very much support, this action, this bill, as I understand it, because it is kind of a win-win from my perspective. It allows the regulators to get on with their mission; it allows us to get on with our job.

Mr. SANDERS. Okay, thank you very much.

Thank you, Mr. Chairman.

Chairman BACHUS. Thank you.

Mr. Sherman?

Mr. SHERMAN. Thank you.

I believe most of the questions have been answered, but that will not get me to be overly brief.

[Laughter.]

It is good to know that this does not involve legislating accounting standards. I believe that you have indicated that this bill has nothing to do with secondary or alternative capital.

Ms. JOHNSON. That is correct.

Mr. SHERMAN. And it has nothing to do with risk-based capital.

Ms. JOHNSON. That is correct.

Mr. SHERMAN. You know, when I studied accounting, the net worth portion of the balance sheet was a combination of retained earnings, paid-in capital, donated capital and whatever capital or net worth one would acquire through the purchase-method merger.

And if you are a creditor, if you are looking at the safety and soundness of an institution, it does not matter what flavor of net worth is there.

And this bill solves that problem by indicating that retained earnings from the predecessor institution and retained earnings from the continuing institution are both capital available to meet needs.

Can anybody think of a reason someone would advance to oppose this bill?

Ms. JOHNSON. No, sir.

Mr. SHERMAN. Next? You are shaking your head, but that will not make the record.

Mr. REYNOLDS. No, absolutely not.

Mr. SHERMAN. And third?

Mr. HERZ. I am not a regulatory capital expert, but, again, from our point of view, since it does not interfere with our setting of generally accepted accounting principles, it seems like a good idea to me.

Mr. SHERMAN. For the first time ever, I yield back before my time is completed.

Chairman BACHUS. Thank you.

We kind of want to set a record for the shortest hearing, and we have had absolutely nothing negative said about this legislation.

I will just make two more points, and that is acquired equity—and Chairman Herz, you said acquired equity is counted as net worth for generally accepted accounting practices.

So what we are proposing doing is really bringing the credit union board, national credit union board, and the act that gives the definitions in line, as far as I am concerned, with generally accepted accounting principles and will actually allow them to follow that method.

The second thing I will say is that I think this is particularly important in that, Ms. Johnson, Chairman Johnson, one of your duties, when you have an institution that for safety or soundness reasons needs to be acquired by a stronger institution, you have to go out and try to find a white knight. And unless we make this change, that is going to be much harder.

Ms. JOHNSON. That is right. We perceive it could be much more difficult to find that necessary merger partner.

Chairman BACHUS. And I am not sure that that has been said yet. But I think that from a standpoint of allowing you to fulfill your mission, this will make it, when we do have an institution that needs to be taken over by a stronger institution, this will make it easier to do that.

Ms. JOHNSON. That is correct.

Mr. Green? I am sorry, and I—

Mr. GREEN. Thank you, Mr. Chairman and Mr. Ranking Member.

When you are a neophyte at the very end of the line, I understand.

[Laughter.]

I understand, and is it an—

Chairman BACHUS. And I apologize to you. I did not realize—

Mr. GREEN. Mr. Chairman, no apology necessary, thank you very much.

And thank you to the members of the panel, because you have truly made this issue transpiculously clear for me. And I want to be as terse and laconic as possible, given that we are setting the record.

But I do want you to know that I appreciate the comment that you made about the troubled credit unions, because I am concerned about the shareholders in those troubled credit unions.

And if they cannot find a suitable partner, ultimately people pay the price, and these are people that have faces and families.

We really appreciate the opportunity to eliminate what could be an injustice as it relates to the families that will suffer.

So I thank you for the information that has been imparted.

And I yield back the rest, remainder and balance of my time, Mr. Chairman.

Chairman BACHUS. Thank you.

This will conclude the hearing.

We do have one or two things.

First of all, I want to thank all the co-sponsors of this bill, including my Ranking Member, Mr. Sanders. I think this is a great example of a noncontroversial legislation that has bipartisan support and apparently no opposition.

So I would hope that we can get this bill on the floor very quickly and pass it over to the Senate.

Co-sponsors include Ms. Brown-Waite, Gutierrez, Kanjorski, LaTourette, McCarthy, Ney, Renzi, Sanders, Feeney, Hooley, Kelly, Maloney, Moore, Ron Paul, Mr. Royce and Mr. Sherman.

It is not often that we have Mr. Sherman and Mr. Sanders and Mr. Paul on the same bill.

[Laughter.]

So this gives you an idea of exactly how much support there is for this legislation.

I want to introduce, without objection, a letter from the National Association of Federal Credit Unions signed by Mr. Becker—I saw him earlier. I would like to submit this for the record, without objection.

So at this time the hearing is closed.

We appreciate your testimony.

We are adjourned.

[Whereupon, at 2:59 p.m., the subcommittee was adjourned.]

A P P E N D I X

April 13, 2005

(13)

Prepared, not delivered

Opening Statement
Chairman Michael G. Oxley
House Financial Services Committee

**Hearing of the Subcommittee on Financial Institutions
and Consumer Credit**

**H.R. 1042, Net Worth Amendment for Credit Unions Act
April 13, 2005**

I commend Chairman Bachus for convening this hearing on H.R. 1042, the Net Worth Amendment for Credit Unions Act, bipartisan legislation which addresses specific unintended consequences that a Financial Accounting Standards Board (FASB) accounting rule will have on credit union mergers.

FASB's Statement of Financial Accounting Standard 141, scheduled to take effect for mutual enterprises such as credit unions early next year, requires credit unions to follow purchase method accounting rules when calculating the retained earnings of a credit union that results from a merger. Under purchase method accounting, the retained earnings of the acquired credit union in a merger become part of the acquired equity — but not the retained earnings — of the surviving credit union, potentially resulting in a significant understatement of the credit union's net worth — and thus its capital — for purposes of the prompt corrective action (PCA) requirements of the Federal Credit Union Act.

H.R. 1042 remedies this unintended consequence by amending the Federal Credit Union Act's definition of net worth so that the retained earnings of both credit unions in a merger transaction count toward the net worth of the surviving entity. Without this statutory change, credit unions will face an extremely high hurdle when considering whether to merge with another institution, because in many circumstances, such mergers will mean a radical reduction in capital, leading to the possible imposition of regulatory constraints on growth and other operations of the credit union. The National Credit Union Administration (NCUA) has pointed out that this disincentive to credit union mergers will complicate its task of finding willing acquirers of troubled credit unions, which could in turn increase costs on the deposit insurance fund that the NCUA administers for the benefit of credit union members.

It is important to highlight that H.R. 1042 is non-controversial legislation that provides a narrow statutory fix, and does not touch on the more contentious issue of secondary capital for credit unions, which was the subject of a recent study by the Government Accountability Office (GAO) that Mr. Frank, Mr. Sherman and I commissioned. It should also be emphasized that FASB has assured the Committee

that H.R. 1042 in no way undermines or negatively affects its authority to set general-purpose accounting standards for both public and private enterprises. Rather, this legislation simply ensures that the tools the NCUA presently have are preserved after the FASB rule goes into effect, which will help to maintain the safety and soundness of the credit union industry and ultimately benefit the members and communities they serve.

In closing, let me again commend Chairman Bachus and the cosponsors of his legislation, and also welcome back to the Committee NCUA Chairman JoAnn Johnson, who was instrumental in calling the issue addressed by H.R. 1042 to the Committee's attention last year.

I yield back the balance of my time.

**OPENING STATEMENT OF CHAIRMAN SPENCER
BACHUS
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND
CONSUMER CREDIT
H.R. 1042, THE NET WORTH AMENDMENT FOR CREDIT
UNIONS ACT
APRIL 13, 2005**

Good afternoon. The subcommittee will come to order. Today's hearing is on H.R. 1042, the Net Worth for Credit Unions Act. H.R. 1042 — which Ranking Member Sanders and I introduced last month along with fourteen cosponsors — is designed to address the potentially harmful and unintended consequences of a recently proposed Financial Accounting and Standards Board (FASB) accounting rule on credit union mergers. Because this new accounting rule is expected to become effective early next year, the Committee plans to mark up H.R. 1042 at the end of the month, and I hope that the House will pass the legislation soon thereafter.

Under the current FASB rule, credit unions are able to use the "pooling of interests" method of accounting for mergers; however, the new rule will require use of the "purchase method." Under the latter approach, an institution is not permitted to bring over the retained earnings of the acquired institution onto its own balance sheet as retained earnings, but rather as "acquired equity." Thus, the surviving institution would not be able to count the retained earnings of the "merged" institution in its net worth for Prompt Corrective Action (PCA) purposes under the Federal Credit Union Act. This could have the effect of unintentionally lowering the merged credit union's net worth category classification.

The practical consequences of FASB's directive changing the accounting treatment of credit union mergers from the "pooling method" to the "purchase method" are perhaps best illustrated by considering a simple hypothetical.

Under the “pooling method” previously used to account for a combination of two credit unions, if a credit union with \$2 million in retained earnings merged with a credit union with \$2 million in retained earnings, the surviving credit union had \$4 million in retained earnings, which counted as its “net worth” for purposes of applying the PCA capital requirements outlined above. However, under the “purchase method” of accounting mandated by the new FASB rule, if a credit union with \$2 million in retained earnings merges with another credit union with \$2 million in retained earnings, the surviving credit union will only have \$2 million in retained earnings.

H.R. 1042 amends the Federal Credit Union Act to ensure that when credit unions merge, $2 + 2$ will continue to equal 4. The legislation simply amends the Federal Credit Union Act’s definition of “net worth” to include the retained earnings of **both** credit unions that merge in the “net worth” of the credit union that continues after the transaction is completed. Failure to make this statutory change will create major disincentives to otherwise desirable credit union mergers. A credit union seeking to merge with another institution would be faced in many situations with a marked decline in its capital for PCA purposes once the merger went through, giving rise to supervisory intervention by the NCUA designed to limit its growth and restore its now-depleted capital to acceptable levels.

Moreover, when a federally insured credit union becomes troubled and the NCUA seeks a healthy credit union to rescue it through a merger, the pool of potential “white knights” will surely be limited by the prospect of a significant post-merger reduction in capital for the acquiring credit union. This will inevitably make NCUA-assisted mergers more difficult to execute, resulting in more credit union failures and higher costs to the National

Credit Union Share Insurance Fund, which insures the deposits of credit union members.

For this reason, among others, the NCUA strongly supports H.R. 1042, arguing that it is necessary both to ensure an accurate depiction of net worth in credit union mergers and to avoid creating unintended obstacles to mergers that would otherwise benefit credit union members. In addition, FASB has stated that while it does not take positions on public policy initiatives unless they could impair the mission and independence of FASB, it believes that H.R. 1042 “does not propose to establish or change general-purpose standards of financial accounting and reporting, [and therefore] has no impact on the standard setting activities of the FASB.”

In closing, I want to thank Mr. Sanders, Chairman Oxley and Ranking Member Frank for working with me on this legislation. I look forward to working with them and other Members of the subcommittee on this technical but important issue.

The chair now recognizes the Ranking Member of the Subcommittee, Mr. Sanders, for any opening statement he would like to make.

**Opening Statement
Rep. Ed Royce (CA-40)
"Net Worth Amendment for Credit Unions Act"
13 April 2005**

Chairman Bachus, I would like to thank you for holding this hearing and for introducing H.R. 1042, the "Net Worth Amendment for Credit Unions Act." I am a supporter and an original cosponsor of the bill.

Credit Unions currently serve over 85 million Americans, which makes the credit union industry an important part of our nation's financial system. Credit unions are an engine of economic activity and growth -- helping Americans finance the purchase of homes and cars, save for college and retirement, and access capital for small business investment.

Currently, when one credit union acquires another credit union the retained earnings of the acquired credit union do not accrue, for statutory purposes, to the retained earnings of the acquirer. This rule results in the newly created credit union having an arbitrarily low reported net worth. H.R. 1042 amends the statutory definition of a credit union's net worth to allow the retained earnings of both firms to count as net worth in the newly combined entity. My hope is that Congress will move swiftly to correct this issue.

I look forward to the testimony of today's witnesses. Again, Chairman Bachus thank you for having this hearing. I yield back.



**Testimony of
Robert H. Herz
Chairman
Financial Accounting Standards Board
before the
Financial Institutions and Consumer Credit Subcommittee
of the
Committee on Financial Services
April 13, 2005**

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**Testimony of
Robert H. Herz
Chairman
Financial Accounting Standards Board
before the
Financial Institutions and Consumer Credit Subcommittee
of the
Committee on Financial Services
April 13, 2005**

Prepared Statement

Chairman Bachus, Ranking Member Sanders, and Members of the Subcommittee:

Good afternoon. I am Robert Herz, chairman of the Financial Accounting Standards Board ("FASB" or "Board"). I am pleased to appear before you today on behalf of the FASB. I want to thank you for inviting me to participate at this very important and timely hearing.

I have brief prepared remarks and would respectfully request that the full text of my testimony and all supporting materials be entered into the public record.

The FASB is an independent private-sector organization. Our ability to conduct our work in a systematic, thorough, and unbiased manner is fundamental to achieving our mission—to establish and improve general-purpose standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the growth and stability of the United States economy because creditors, investors, and other consumers of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make economic decisions. In other words, financial accounting and reporting is meant to tell it like it is, not to distort or skew information to favor particular industries, types of transactions, or particular political, social, or economic goals other than the goal of sound and honest reporting.

Because the actions of the FASB affect so many organizations, our decision-making process must be open, thorough, and as objective as possible. Our Rules of Procedure require an extensive and public due process. That process involves public meetings, public roundtables, field visits, liaison meetings with interested parties, consultation with our advisory councils, and exposure of our proposed standards to external scrutiny and public comment.

In June of 2001, after several years of extensive public due process, the Board issued a standard to improve the accounting and financial reporting for business combinations. That standard, strongly supported by many users, auditors, and preparers of financial reports, provides that all business combinations be accounted by a single method—the purchase method. The standard thus eliminated an existing alternative method of accounting for business combinations—the pooling-of-interests method.

In developing the standard the Board decided to defer its effective date for combinations between credit unions and other mutual enterprises. The Board concluded that the deferral was appropriate so that the Board could consider the need for additional interpretative guidance explaining how the purchase method might be applied by those enterprises.

Since the issuance of the standard, the Board has continued to specifically discuss combinations between mutual enterprises at eight public Board meetings. In connection with those meetings, individual Board members and staff sought input on the issue from many representatives of credit unions and other mutual enterprises at public and private meetings and at conferences across the country.

The Board has tentatively affirmed the conclusion reached in our 2001 standard on business combinations that combinations between credit unions and other mutual enterprises should be accounted for as acquisitions of businesses under the purchase method consistent with the accounting for such transactions applied by all other types of business enterprises. In addition, the Board has developed proposed changes to improve the procedures for applying the purchase method, which includes additional interpretative guidance to assist credit unions and other mutual enterprises in applying that method.

The Board plans to include its tentative decisions for mutual enterprises together with the other tentative decisions on applying the purchase method in a proposal for public comment. That proposal is expected to be issued for comment by the end of June.

Following the comment period, the Board will, at public meetings over a period of months, carefully consider the comments and other input received from credit unions and other enterprises in response to the proposal. As with virtually all FASB projects, the public redeliberations will likely result in a number of changes to clarify and improve the proposal. Only after carefully evaluating the key issues raised and carefully considering the input received in response to the proposal will the Board consider whether to issue a final standard.

We have reviewed the provisions of H.R. 1042, the “Net Worth Amendment For Credit Unions Act” (“H.R. 1042”). Consistent with the FASB’s mission and expertise the Board does not take positions on proposed legislation or other public policy initiatives, except in those limited circumstances when those initiatives would impair the mission and independence of the FASB.

We observe that the provisions of H.R. 1042 appear to revise the definition of net worth as defined under the Federal Credit Union Act (“Act”). The proposed revision of that definition appears to resolve a potential regulatory issue that some in the credit union industry believe, if not resolved, would have adverse consequences for merged credit unions.

We also observe that the provisions of H.R. 1042 do not appear to establish or change general-purpose standards of financial accounting and reporting. We, therefore, very much appreciate, Mr. Chairman, your leadership in addressing this important matter in such a thoughtful and appropriate manner.

Thank you again, Mr. Chairman. I would welcome the opportunity to respond to any questions.



**Testimony of
Robert H. Herz
Chairman
Financial Accounting Standards Board
before the
Financial Institutions and Consumer Credit Subcommittee
of the
Committee on Financial Services
April 13, 2005**

Full Text of Testimony

Chairman Bachus, Ranking Member Sanders, and Members of the Subcommittee:

I am Robert Herz, chairman of the Financial Accounting Standards Board (“FASB” or “Board”). I am pleased to appear before you today on behalf of the FASB.

My testimony includes a brief overview of (1) the FASB, including the importance of the Board’s independence, (2) the process the FASB follows in developing accounting standards, (3) the Board’s project to improve the accounting for combinations between mutual enterprises, and (4) some comments and observations about H.R. 1042, the “Net Worth Amendment For Credit Unions Act.”

The FASB

The FASB is an independent private-sector organization.¹ We are not part of the federal government. Our independence from enterprises, auditors, and the federal government is fundamental to achieving our mission—to establish and improve general-purpose standards of financial accounting and reporting for both public and private enterprises, including credit unions, other mutual enterprises, and not-for-profit organizations. Those standards are essential to the efficient functioning and operation of the capital markets and the United States (“US”) economy because creditors, investors, and other consumers of financial reports rely heavily on sound, honest, and unbiased financial information to make rational credit, investment, and other resource allocation decisions.

The FASB’s independence, the importance of which was recently reaffirmed by the Sarbanes-Oxley Act of 2002,² is fundamental to our mission because our work is technical in nature, designed to provide preparers with the guidance necessary to report information about their economic activities. Our standards are the basis to measure and report on the underlying economic transactions of business enterprises. Like creditors and investors, Congress and other policy makers need an independent FASB to maintain the integrity of the standards in order to obtain the financial information necessary to properly assess and implement the public policies they favor.

Financial accounting and reporting is meant to tell it like it is, not to allow distortions or skew information to favor particular industries, particular types of transactions, or particular political, social, or economic goals other than sound and honest reporting. While bending the standards to favor a particular outcome may seem attractive to some in the short run, in the long run a biased accounting

¹ See Attachment 1 for information about the Financial Accounting Standards Board.
² Sarbanes-Oxley Act of 2002, Public Law Number 107-204, Sections 108-109.

standard is harmful to creditors, investors, the capital markets, and the US economy.

The Securities and Exchange Commission (“SEC”), together with the private-sector Financial Accounting Foundation (“FAF”),³ maintains active oversight of the FASB’s activities.

The FASB’s Public Due Process in Developing Accounting Standards

Because the actions of the FASB affect so many organizations, its decision-making process must be open, thorough, and as objective as possible. The FASB carefully considers the views of all interested parties, including users, auditors, and preparers of financial reports of both public and private enterprises, including credit unions.

Our Rules of Procedure require an extensive and thorough public due process.⁴ That process involves public meetings, public roundtables, field visits, liaison meetings with interested parties, and exposure of all proposed standards to external scrutiny and public comment. The FASB members and staff also regularly meet informally with a wide range of interested parties to obtain their input and to better our understanding of their views. The Board makes final decisions only after carefully considering and analyzing the input of all interested parties.

While our process is similar to the Administrative Procedure Act process used for federal agency rule making, it provides for far more public deliberations of the relevant issues and far greater opportunities for interaction with the Board by all interested parties. It also is focused on making technical, rather than policy or legal, judgments. The FASB’s Mission Statement and Rules of Procedure require that in making those judgments the Board must balance the often conflicting perspectives of various interested parties and make independent, objective decisions guided by the fundamental concepts and key qualitative characteristics of financial reporting set forth in our conceptual framework.

The FASB and the FAF, in consultation with interested parties, periodically review the FASB’s due process procedures to ensure that the process is working efficiently and effectively for users, auditors, and preparers of financial reports.⁵ In recent years, the FASB and the FAF have undertaken a significant number of

³ See Attachment 1 for information about the Financial Accounting Foundation.

⁴ See Attachment 1 for information about the FASB’s due process.

⁵ The SEC also recently reviewed the FASB’s due process and concluded that “the FASB has the capacity . . . and is capable of improving both the accuracy and effectiveness of financial reporting . . .” Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, page 5 of 8 (April 2003).

actions to improve the Board's due process procedures. Some of those actions build on and enhance the quality and breadth of input to our process, including increasing the input from users, auditors, and preparers of small businesses, including mutual enterprises. Those particular actions include the following:

- Establishing a Small Business Advisory Committee ("SBAC") in order to increase involvement by the small business community in developing accounting standards. The SBAC, whose members represent diverse perspectives and experiences, comprises lenders, investors and analysts, preparers of financial statements from a broad range of businesses, including controllers and chief financial officers, and auditors from the small business community. The SBAC currently has two members representing preparers from mutual enterprises, including a senior vice president and chief financial officer of a credit union.
- Establishing a User Advisory Council ("UAC") in order to obtain more active user involvement in our process. The UAC comprises representatives of individual and institutional investors, investment and commercial banks, rating agencies, and other groups that represent investors and key users. Several of the members of the UAC are primarily users of financial reports of small businesses.

Other recent initiatives include:

- Making our public Board meeting announcements available to interested parties more broadly through a free email subscription service.
- Making our public Board meetings available to interested parties for monitoring via web cast on our website free of charge and via the telephone at a reduced cost.
- Making all of our proposals for public comment, all of the comments received, and the full text of all our standards publicly available on our website free of charge.

The FASB's Current Project to Improve the Accounting for Combinations between Mutual Enterprises

Background

In August 1996, in response to requests from a broad range of users, auditors, and preparers of financial statements, the Board added to its agenda a multi-part project to reconsider the existing accounting guidance for business combinations and goodwill and other intangible assets. The existing guidance permitted the

business combinations of all enterprises, including credit unions and other mutual enterprises, to be accounted for using one of two methods, the pooling-of-interests method (“pooling”) or the purchase method.⁶ Use of pooling was required whenever 12 criteria were met; otherwise, the purchase method was to be used. Because those 12 criteria did not distinguish economically dissimilar transactions, similar business combinations were accounted for using different methods that produced dramatically different financial results. Consequently:

- Analysts and other users of financial statements indicated that it was difficult to compare the financial results of enterprises because different methods of accounting for business combinations were used.
- Users of financial statements also indicated a need for better information about intangible assets because those assets were an increasingly important economic resource for many enterprises and an increasing proportion of the assets acquired in many business combinations. While the purchase method recognizes all intangible assets acquired in a business combination (either separately or as goodwill), only those intangible assets previously recorded by the acquired entity are recognized when pooling is used.
- Company managements indicated that the differences between pooling and purchase methods of accounting for business combinations affected competition in markets for mergers and acquisitions.

The Board conducted over four years of research, deliberations, and other public due process in addressing issues relating to the accounting for business combinations and goodwill and intangible assets. That due process included the following:

- The formation of and active consultation with a business combinations task force comprising individuals from a number of organizations representing a wide range of the Board’s constituents.
- The issuance of a Special Report for public comment.⁷ The 54 comment letters received in response to that Special Report generally expressed agreement with the Board’s initial decisions about the project’s scope, direction, and conduct.

⁶ The existing guidance on accounting for business combinations and goodwill and intangible assets had been largely provided by Accounting Principles Board (“APB”) Opinions No. 16, *Business Combinations* (August 1970), and No. 17, *Intangible Assets* (August 1970).

⁷ FASB Special Report, *Issues Associated with the FASB Project on Business Combinations* (June 1997).

- The issuance of a Position Paper for public comment developed by an organization known as the “Group of 4 plus 1” (G4+1).⁸ The G4+1 consisted of the Australian Accounting Standards Board (“AASB”), the New Zealand Financial Reporting Standards Board (“FRSB”), the United Kingdom Accounting Standards Board (“UK ASB”), the Accounting Standards Board of the Canadian Institute of Chartered Accountants (“AcSB”), the FASB, and an observer, the International Accounting Standards Committee (“IASC”). The Position Paper concluded that only the purchase method should be used for business combinations of all enterprises. The FASB received 148 comment letters, the AcSB received 40 letters, the UK ASB received 35 letters, the IASC received 35 letters, the AASB received 5 letters, and the FRSB received 4 letters. The letters were carefully considered by the Board in connection with its public due process.
- The issuance of a proposed standard for public comment. The Board received 210 comment letters in response to the proposal.⁹
- Four days of public hearings, 2 days in San Francisco and 2 days in New York City, at which 43 individuals or organizations presented their views on the proposed standard.
- Field visits with 14 enterprises during which the Board and FASB staff members explored suggested changes to the proposed standard.
- The issuance of a revised proposed standard for public comment that proposed changes to the earlier proposal with regard to the accounting for goodwill and the initial recognition of intangible assets other than goodwill.¹⁰ The Board received 211 comments on the revised proposed standard.

After completing its deliberations and other public due process, the Board decided to separate the guidance for business combinations from that of goodwill and other intangible assets and issue the guidance in two final standards—Statement of Financial Accounting Standards No. 141, *Business Combinations* (June 2001) (“Statement 141”), and Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* (June 2001) (“Statement 142”).

⁸ FASB Invitation to Comment, *Methods of Accounting for Business Combinations: Recommendations of the G4+1 for Achieving Convergence* (December 1998).

⁹ FASB Exposure Draft, *Business Combinations and Intangible Assets* (September 1999).

¹⁰ FASB Revised Exposure Draft, *Business Combinations and Intangible Assets—Accounting for Goodwill* (February 2001).

Statement 142 improved the existing accounting for goodwill and other intangible assets in the following significant respects:

- By providing for an economic-based view of goodwill (as compared with the existing transaction-based view) and basing the accounting for goodwill on the reporting units of the combined enterprise into which an acquired enterprise is integrated.
- By not presuming (as was the existing practice) that intangible assets are wasting assets. Instead, goodwill and intangible assets that have indefinite useful lives are tested at least annually for impairment. Intangible assets that have finite useful lives continue to be amortized over their useful lives, but without the constraint of the arbitrary 40-year ceiling (as was the existing practice).
- By providing specific guidance for testing goodwill impairment.
- By providing for specific guidance for impairment testing of those intangible assets that are not amortized and removing those intangible assets from the scope of other impairment guidance.
- By providing for disclosure of information about goodwill and other intangible assets in the years subsequent to their acquisition that was not previously required.

Likewise, Statement 141 improved the existing accounting for business combinations in the following significant respects:

- By providing that all business combinations be accounted for by a single method—the purchase method, thus eliminating the use of pooling.
- By providing that all intangible assets that meet specified criteria be recognized as assets apart from goodwill.
- By providing for additional disclosures about business combinations.

The requirements of Statements 142 and 141 generally became effective for business combinations and acquired goodwill and intangible assets after June 30, 2001. The Board, however, decided to defer the effective date of the requirements of those Statements for combinations between credit unions and other mutual enterprises. The Board concluded:

For combinations between two or more mutual enterprises, . . . [Statement 141] shall not be effective until interpretative guidance related to the application

of the purchase method to those transactions is issued.¹¹

[Statement 142] shall not be applied to previously recognized goodwill and intangible assets acquired in a combination between two or more mutual enterprises, . . . until interpretative guidance related to the application of the purchase method to those transactions is issued. . . .¹²

Before extending the requirements of Statements 141 and 142 to mutual enterprises, including credit unions, the Board decided to undertake a separate project to develop interpretative guidance related to the application of the purchase method to combinations between mutual enterprises.¹³ In the past those enterprises had applied the existing guidance, which was developed primarily for investor-owned enterprises.

The Board decided that the project should use a “differences-based” approach that presumes that the provisions of Statements 141 and 142 apply to combinations between credit unions and other mutual enterprises, unless conditions of the combination are found to be so different as to warrant a different accounting treatment. The Board noted that differences between combinations of mutual enterprises and combinations of investor-owned enterprises include the lack of equity investors (in the traditional sense) and the greater frequency of combinations without an exchange of cash or other readily identifiable and measurable consideration.

Since October 2001 the Board has held eight public meetings, including a public roundtable and liaison meeting, to discuss issues relating to the project on combinations between mutual enterprises. The Board and staff also have discussed issues related to the project at private liaison meetings and at public conferences with many preparers, auditors, and users of the financial statements of mutual enterprises, including credit unions. The Board also conducted field visits with three types of mutual enterprises, including a credit union, to discuss in detail the application of the Board’s tentative decisions to those enterprises. Concurrently, the AcSB conducted research and public meetings on the same issues and reached the same fundamental conclusions as the Board.

¹¹ Statement 141, paragraph 60. Footnote 24 to paragraph 60 states that “the Board intends to consider issues related to the application of the purchase method to combinations between two or more mutual enterprises in a separate project.”

¹² Statement 142, paragraph 48(c) (footnote reference omitted).

¹³ See Attachment 2 for a summary of the project on Combinations Between Mutual Enterprises.

Tentative Decisions

As a result of the Board's public deliberations in connection with this project to improve the accounting for combinations between mutual enterprises, the Board has reached the following tentative decisions.

First, the Board affirmed that combinations between mutual enterprises for which Statement 141 provided a delayed effective date should be accounted for as acquisitions of businesses under the purchase method. In reaching that decision, the Board observed, as it did in the development of Statement 141, that because virtually all business combinations are acquisitions of an enterprise by an acquiring enterprise, the purchase method of accounting is the method that most fairly represents the underlying economics of the transaction or event at the time the acquiring enterprise obtains control of the acquired enterprise.

The Board rejected the argument made by some mutual enterprises, including some credit unions, that eliminating the application of pooling would impede consolidation within certain industries and, perhaps, misrepresent the financial soundness and regulatory capital of certain mutual enterprises. The Board noted that mutual enterprises are similar to other enterprises in most important economic respects. Consistent with the FASB's commitment to developing neutral standards, the Board concluded that business combinations between credit unions and other mutual enterprises should be accounted for similar to combinations between other enterprises—by using the purchase method of accounting.

Second, the Board decided that certain additional interpretative guidance for applying the purchase method to credit unions and other mutual enterprises should be provided. That additional guidance includes (a) some specific measurement guidance to assist mutual enterprises in estimating the fair value of mutual enterprises acquired and (b) clarifying that in those circumstances in which a combination between mutual enterprises involves an exchange of the equity or member interests of one mutual enterprise for the equity interests of the other mutual enterprise, the fair value of the acquired mutual enterprise should be included as part of the capital or equity in the acquiring mutual enterprise's financial statements. With respect to the latter guidance, some representatives of mutual enterprises suggested that when a combination between mutual enterprises involves an exchange of equity, the fair value of the acquired mutual enterprise should be included as part of the "retained earnings" of the acquirer similar to the existing practice under pooling. The Board has tentatively rejected that view.

The Board concluded that business combinations between two mutual enterprises in which the acquirer issues member interests for the entire member interests of the acquiree are economically similar to those between two investor-owned enterprises and, thus, the accounting for those transactions should be similar.

Moreover, the interests of members are similar to investor equity interests—generally both have liquidation rights and the right to vote on major transactions, such as business combinations.

Cost-Benefit Considerations

The cost-benefit of the Board's tentative decision to eliminate pooling for all business enterprises, including credit unions and other mutual enterprises, was considered in Statement 141. The basis for conclusions of Statement 141 explains:

The Board addressed cost-benefit considerations in developing the 1999 Exposure Draft [which included and was proposed to apply to all business combinations, including combinations between mutual enterprises] and concluded that a single method of accounting is preferable in light of those considerations because having more than one method would lead to higher costs associated with applying, auditing, enforcing, and analyzing the information produced by them. Cost-benefit considerations were thoroughly analyzed at that time and are discussed in paragraphs B225–B234. The Board concluded that those that favor retaining the pooling method on the basis of cost-benefit considerations did not provide any additional information that the Board did not consider previously.¹⁴

As indicated above, roundtable discussions were held specifically with mutual enterprises to gather information about mutual enterprises; combinations of mutual enterprises; concerns with alternative approaches to the purchase method; and difficulties, costs, and benefits of applying different methods.

Also as indicated above, field visits were conducted with three mutual enterprises, including a credit union. One of the objectives of those field visits was to assess and understand the incremental costs that constituents expect to incur, in qualitative terms, in applying the requirement to measure the fair value of the mutual enterprise acquired, particularly when control of that mutual enterprise is achieved through an exchange of member interests. The major concerns expressed in the field visits were among those that the FASB had previously considered.

¹⁴ Statement 141, paragraph B68.

The Board's tentative decisions will be exposed for comment as part of a proposed standard that will solicit additional input on all aspects of the proposal, including the costs and benefits of the proposed accounting for business combinations between mutual enterprises. Consistent with the FASB's Rules of Procedure, the Board will carefully evaluate the input received as part of its public redeliberations relating to the project.

Interaction of the Board's Tentative Decisions and the Federal Credit Union Act

During the development of the Board's tentative decisions described above, some representatives of credit unions raised specific concerns about the potentially adverse economic consequences of the tentative decisions for those enterprises. More specifically, some noted that the Federal Credit Union Act ("Act") defines net worth as the "retained earnings balance of the credit union, as determined under generally accepted accounting principles." Because the regulatory definition of net worth is narrower than "equity" as defined under generally accepted accounting principles ("GAAP"), those representatives expressed the concern that the tentative decision to exclude the equity of an acquired credit union from retained earnings of the combined enterprise would misrepresent a financially sound combined enterprise as if it were not financially sound. Some also suggested that credit unions be permitted to (a) continue to apply pooling for their combinations or (b) report the equity of an acquired credit union as an addition to retained earnings of the combined enterprise. The Board has tentatively rejected those arguments.

The Board believes that the tentative decisions will generally not affect the ability of credit unions to restructure and combine with other credit unions. For example, the Board has been informed by experts in the credit union industry that the number of combinations between credit unions in which the regulatory net worth calculation could be significantly impacted is relatively small in any given year.

More importantly, the Board noted that its decisions apply to general-purpose financial statements of all enterprises and that regulatory filings of credit unions and other enterprises and the needs of their regulators are separate matters beyond the purpose of those financial statements. The Board's conceptual framework states that a necessary and important characteristic of accounting information is neutrality. In the context of business combinations, neutrality means that the accounting standards should neither encourage nor discourage business combinations but, rather, provide information about those combinations that is fair and evenhanded.

The Board has tentatively concluded that, consistent with the Board's mission, its public policy goal is to issue accounting standards that result in neutral and representationally faithful financial information. The elimination of pooling for

all enterprises and the requirement that all enterprises, including credit unions, report the resulting increase in equity as a result of a business combination as a direct addition to equity are consistent with that goal.

Status and Plans

The Board has substantially completed its public deliberations relating to its project on combinations between mutual enterprises. The Board's tentative decisions on this project are expected to be combined with the tentative decisions that the Board has developed in connection with a related project to improve the existing guidance for applying the purchase method of accounting into a single proposed standard for public comment.¹⁵ Later this month, the Board, at public meetings, will address the length of the comment period and the proposed effective date.

The Board currently expects to issue the proposed standard for public comment by the end of June. Following the comment period, the Board will, at public meetings over a period of months, carefully consider all of the comment letters and other input received from all parties.

As with virtually all FASB projects, the redeliberations will likely result in a number of suggested changes to clarify and improve the proposed standard. Only after carefully evaluating all of the key issues and carefully considering the input received in response to the proposal will the Board consider whether to issue a final standard. No final standard may be issued without approval by a majority vote of the Board. As with all of the FASB's activities, the FAF and the SEC staff will monitor and oversee the Board's due process on this important project.

Some Comments and Observations about H.R. 1042

As indicated above, the mission of the FASB is to establish and improve general-purpose standards of financial accounting and reporting for both public and private enterprises, including credit unions and other mutual enterprises. Those standards are essential to the efficient functioning of the economy because creditors, investors, and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make rational resource allocation decisions.

¹⁵ See Attachment 3 for a summary of the project on Business Combinations: Purchase Method Procedures (including Combinations Between Mutual Enterprises) and Certain Issues Related to the Accounting for and Reporting of Noncontrolling (Minority) Interests. The FASB and the International Accounting Standards Board are working cooperatively to develop common proposed standards in connection with this project.

Consistent with the FASB's mission and expertise the Board does not take positions on proposed legislation or other public policy initiatives, except in those limited circumstances when those initiatives would impair the mission and the independence of the FASB.

Per review of the provisions of H.R. 1042, the FASB observes that the proposed legislation appears to seek to revise the definition of net worth under the Act for purposes of assessing the regulatory capital adequacy of credit unions pursuant to the Act. As such, the proposed legislation does not appear to establish or change general-purpose standards of financial accounting and reporting. Therefore, the proposed legislation has no impact on the standard-setting activities of the FASB or GAAP.

Conclusion

In conclusion, the Board's project to improve the accounting for combinations between mutual enterprises has resulted in a package of tentative decisions that will soon be exposed for public comment. The Board is committed to carefully considering the input received in response to the proposed standard. That input will be considered in an open, thorough, and objective manner.

Our ultimate goal is to develop an accounting standard that will faithfully report the underlying economic effects of combinations between public and private enterprises, including credit unions, in a cost-effective manner and, thus, improve the transparency and integrity of financial reporting in the United States and abroad.

We observe that the provisions of H.R. 1042 appear to revise the definition of net worth as defined under the Act. The proposed revision of that definition appears to resolve a potential regulatory issue that some in the credit union industry believe, if not resolved, would have adverse consequences for merged credit unions.

We also observe that the provisions of H.R. 1042 do not appear to establish or change general-purpose standards of financial accounting and reporting. We, therefore, very much appreciate, Mr. Chairman, your leadership in addressing this important matter in such a thoughtful and appropriate manner.

Thank you again, Mr. Chairman. I would welcome the opportunity to respond to any questions.



**Testimony of
Robert H. Herz
Chairman
Financial Accounting Standards Board
before the
Financial Institutions and Consumer Credit Subcommittee of the
Committee on Financial Services
April 13, 2005**

Attachment 1

FACTS about FASB

FACTS ABOUT FASB 2005

401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116 • www.fasb.org

Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards of financial accounting and reporting. Those standards govern the preparation of financial reports. They are officially recognized as authoritative by the Securities and Exchange Commission (Financial Reporting Release No. 1, Section 101 and reaffirmed in its April 2003 Policy Statement) and the American Institute of Certified Public Accountants (Rule 203, Rules of Professional Conduct, as amended May 1973 and May 1979). Such standards are essential to the efficient functioning of the economy because investors, creditors, auditors and others rely on credible, transparent and comparable financial information.

The Securities and Exchange Commission (SEC) has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the Commission's policy has been to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest.

THE MISSION OF THE FINANCIAL ACCOUNTING STANDARDS BOARD

The mission of the Financial Accounting Standards Board (FASB) is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors and users of financial information.

Accounting standards are essential to the efficient functioning of the economy because decisions about the allocation of resources rely heavily on credible, concise, transparent and understandable financial information. Financial information about the operations and financial position of individual entities also is used by the public in making various other kinds of decisions.

To accomplish its mission, the FASB acts to:

- Improve the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability and on the qualities of comparability and consistency;
- Keep standards current to reflect changes in methods of doing business and changes in the economic environment;
- Consider promptly any significant areas of deficiency in financial reporting that might be improved through the standard-setting process;

Financial Accounting Standards Board
Serving the investing public through transparent information resulting from high-quality financial reporting standards, developed in an independent, private-sector, open due process.

- Promote the international convergence of accounting standards concurrent with improving the quality of financial reporting; and
- Improve the common understanding of the nature and purposes of information contained in financial reports.

The FASB develops broad accounting concepts as well as standards for financial reporting. It also provides guidance on implementation of standards. Concepts are useful in guiding the Board in establishing standards and in providing a frame of reference, or conceptual framework, for resolving accounting issues. The framework will help to establish reasonable bounds for judgment in preparing financial information and to increase understanding of, and confidence in, financial information on the part of users of financial reports. It also will help the public to understand the nature and limitations of information supplied by financial reporting.

The Board's work on both concepts and standards is based on research aimed at gaining new insights and ideas. Research is conducted by the FASB staff and others, including foreign national and international accounting standard-setting bodies. The Board's activities are open to public participation and observation under the "due process" mandated by formal Rules of Procedure. The FASB actively solicits the views of its various constituencies on accounting issues.

The Board follows certain precepts in the conduct of its activities. They are:

- To be objective in its decision making* and to ensure, insofar as possible, the neutrality of information resulting from its standards. To be neutral, information must report economic activity as faithfully as possible without coloring the image it communicates for the purpose of influencing behavior in any particular direction.
- To weigh carefully the views of its constituents* in developing concepts and standards. However, the ultimate determinant of concepts and standards must be the Board's judgment, based on research, public input and careful deliberation about the usefulness of the resulting information.
- To promulgate standards only when the expected benefits exceed the perceived costs.* While reliable, quantitative cost-benefit calculations are seldom possible, the Board strives to determine that a proposed standard will meet a significant need and that the costs it imposes, compared with possible alternatives, are justified in relation to the overall benefits.
- To bring about needed changes in ways that minimize disruption to the continuity of reporting practice.* Reasonable effective dates and transition provisions are established when new standards are introduced. The Board considers it desirable that change be evolutionary to the extent that it can be accommodated by the need for relevance, reliability, comparability and consistency.
- To review the effects of past decisions* and interpret, amend or replace standards in a timely fashion when such action is indicated.

The FASB is committed to following an open, orderly process for standard setting that precludes placing any particular interest above the interests of the many who rely on

financial information. The Board believes that this broad public interest is best served by developing neutral standards that result in accounting for similar transactions and circumstances in a like manner and different transactions and circumstances should be accounted for in a different manner.

AN INDEPENDENT STRUCTURE

Financial Accounting Standards Board (FASB)

The FASB is part of a structure that is independent of all other business and professional organizations. Before the present structure was created, financial accounting and reporting standards were established first by the Committee on Accounting Procedure of the American Institute of Certified Public Accountants (1936–1959) and then by the Accounting Principles Board, also a part of the AICPA (1959–1973). Pronouncements of those predecessor bodies remain in force unless amended or superseded by the FASB.

Financial Accounting Standards Advisory Council (FASAC)

The FASAC has responsibility for consulting with the FASB as to technical issues on the Board's agenda, project priorities, matters likely to require the attention of the FASB, selection and organization of task forces and such other matters as may be requested by the FASB or its Chairman. At present, the Council has more than 30 members who are broadly representative of preparers, auditors and users of financial information.

Financial Accounting Foundation (FAF)

The FAF, which was incorporated to operate exclusively for charitable, educational, scientific and literary purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code, is responsible for selecting the members of the FASB and its advisory council, ensuring adequate funding of their activities and exercising general oversight with the exception of the FASB's resolution of technical issues.

Governmental Accounting Standards Board (GASB)

In 1984, the Foundation established the GASB to set standards of financial accounting and reporting for state and local governmental units. As with the FASB, the Foundation is responsible for selecting its members, ensuring adequate funding and exercising general oversight.

Trustees

The Foundation is separate from all other organizations. However, its Board of Trustees is made up of members from constituent organizations having interest in financial reporting. Nominees from constituent organizations are approved by the Trustees. There also are Trustees-at-large who are not nominated by those organizations, but are chosen by the sitting Trustees. The constituent organizations are:

FAF Constituent Organizations

- American Accounting Association
- American Institute of Certified Public Accountants

- CFA Institute
- Financial Executives International
- Government Finance Officers Association
- Institute of Management Accountants
- National Association of State Auditors, Comptrollers and Treasurers
- Securities Industry Association

The members of the FAF Board of Trustees are:

- Robert E. Denham (Chairman of the Board and President, FAF), Senior Partner, Munger, Tolles & Olson LLP;
- Frank C. Minter (Vice President, FAF), Retired Vice President and Chief Financial Officer, AT&T International;
- Douglas R. Ellsworth (Secretary and Treasurer, FAF), Director of Finance, Village of Schaumburg, Illinois;
- W. Steve Albrecht, Associate Dean of the Marriott School of Management and Professor, Brigham Young University;
- Philip D. Ameen, Vice President & Comptroller, General Electric Company;
- Barbara H. Franklin, President and Chief Executive Officer, Barbara Franklin Enterprises;
- William H. Hansell, Executive Director Emeritus, International City/County Management Association;
- Richard D. Johnson, Former Auditor of State, Iowa;
- Edward W. Kelley, Jr., Former Governor, Federal Reserve System;
- Duncan M. McFarland, Former Chairman and Chief Executive Officer, Wellington Management Company;
- Eugene D. O'Kelly, Chairman and Chief Executive Officer, KPMG LLP;
- Lee N. Price, President and Chief Executive Officer, Price Performance Measurement Systems, Inc.;
- James H. Quigley, Chief Executive Officer, Deloitte & Touche USA LLP;
- Ned V. Regan, University Professor, The City University of New York; and
- Paul C. Wirth, Global Controller and Chief Accounting Officer, Credit Suisse First Boston.

AN OPEN DECISION-MAKING PROCESS

Actions of the FASB have an impact on many organizations within the Board's large and diverse constituency. It is essential that the Board's decision-making process be evenhanded. Accordingly, the FASB follows an extensive "due process" that is open to public observation and participation. This process was modeled on the Federal Administrative Procedure Act and, in several respects, is more demanding.

HOW TOPICS ARE ADDED TO THE FASB'S TECHNICAL AGENDA

The FASB receives many requests for action on various financial accounting and reporting topics from all segments of its diverse constituency, including the SEC. The auditing profession is sensitive to emerging trends in practice and, consequently, it is a frequent source of requests. Requests for action include both new topics and suggested review or reconsideration of existing pronouncements.

The FASB is alert to trends in financial reporting through observation of published reports, liaison with interested organizations and discussions with the EITF—see page seven. In addition, the staff receives many technical inquiries which may provide evidence that a particular topic, or aspect of an existing pronouncement, has become a problem. The FASB also is alert to changes in the financial reporting environment that may be brought about by new legislation or regulatory decisions.

The Board turns to many other organizations and groups for advice and information on various matters, including its agenda. Among the groups with which liaison is maintained are the Accounting Standards Executive Committee (AcSEC) and Auditing Standards Board of the AICPA, the Public Company Accounting Oversight Board, the International Accounting Standards Board (IASB), and the appropriate committees of such organizations as CFA Institute, Financial Executives International (FEI) and Institute of Management Accountants (IMA). As part of the agenda process, the Board may make available for public comment agenda proposals that concisely describe the scope of potential projects. The Financial Accounting Standards Advisory Council (FASAC) regularly reviews the Board's agenda priorities and consults on all major projects added to the technical agenda. The FASB's User Advisory Council and Small Business Advisory Committee also serve as resources to the Board both in formulating the FASB technical agenda and in advising on specific agenda projects.

After receiving input from the constituency, the Board must make its own decisions regarding its technical agenda. To aid in the decision-making process, the Board has developed a list of factors to which it refers in evaluating proposed topics.

Those factors include consideration of:

- *Pervasiveness of the issue*—the extent to which an issue is troublesome to users, preparers, auditors or others; the extent to which there is diversity of practice; and the likely duration of the issue (i.e., whether transitory or likely to persist);
- *Alternative solutions*—the extent to which one or more alternative solutions that will improve financial reporting in terms of relevance, reliability and comparability are likely to be developed;
- *Technical feasibility*—the extent to which a technically sound solution can be developed or whether the project under consideration should await completion of other projects;
- *Practical consequences*—the extent to which an improved accounting solution is likely to be acceptable generally, and the extent to which addressing a particular subject (or not addressing it) might cause others to act, e.g., the SEC or Congress;

- *Convergence possibilities*—the extent to which there is an opportunity to eliminate significant differences in standards or practices between the U.S. and other countries with a resulting improvement in the quality of U.S. standards; the extent to which it is likely that a common solution can be reached; and the extent to which any significant impediments to convergence can be identified;
- *Cooperative opportunities*—the extent to which there is international support by one or more other standard setters for undertaking the project jointly or through other cooperative means with the FASB; and
- *Resources*—the extent to which there are adequate resources and expertise available from the FASB, the IASB or another standard setter to complete the project; and whether the FASB can leverage off the resources of another standard setter in addressing the issue (and perhaps thereby add the project at a relatively low incremental cost).

It is not possible to evaluate the above factors in precisely the same way and to the same extent in every instance, but identification of factors to be considered helps to bring about consistent decisions regarding the Board's technical agenda.

Accessibility of Meetings

The core of the Board's due process is open decision-making meetings and exposure of proposed standards for public comment. All technical decisions are made in meetings (generally held at the FASB's offices) that are open to public observation, although observers do not participate in the discussions. A live broadcast of such meetings is available free of charge on the FASB website. Each meeting broadcast is also archived and available on the FASB website for one week following the meeting. Each public meeting is announced in advance through the FASB *Action Alert*. Decisions reached are also published in *Action Alert*.

The staff presents written material, including analysis and recommendations, to the Board members in advance as the basis for discussion in a Board meeting. The written material is the result of extensive research by the staff, including a detailed review and analysis of all of the significant alternative views for each issue to be discussed at the meeting. The meeting format calls for oral presentation of a summary of the written materials by the staff, followed by Board discussion of each issue presented and questioning of the staff on the points raised. The Board may reach conclusions on one or more of the issues presented. Any conclusions reached are tentative and may be changed at future Board meetings.

Public Exposure of Standards

Each FASB Statement or Interpretation is issued in draft form (Exposure Draft) for public comment. When the Board has reached conclusions on the issues, it directs the staff to prepare a proposed Exposure Draft for consideration by the Board. After further discussion and revisions, Board members vote by written ballot to issue the Exposure Draft. A majority vote of the Board is required to approve a document for issuance as an

Exposure Draft. Alternative views, if any, are explained in the document and posted on the FASB website.

The Exposure Draft sets forth the proposed standards of financial accounting and reporting, the proposed effective date and method of transition, background information, and an explanation of the basis for the Board's conclusions.

At the end of the exposure period, which is determined at the discretion of the Board but should never be less than 30 days, all comment letters and position papers are analyzed by the staff. This is a search for new information and persuasive arguments regarding the issues; it is not intended to be simply a "nose count" of how many support or oppose a given point of view. In addition to studying this analysis, Board members review the comment letters to help them in reaching conclusions.

Further Deliberation of the Board

After the comments have been analyzed and studied, the Board redeliberates the issues. As in earlier stages of the process, all Board meetings are open to public observation. The Board considers comments received on the Exposure Draft, and often incorporates suggested changes in the final document. If substantial modifications appear to be necessary, the Board may decide to issue a revised Exposure Draft for additional public comment. When the Board is satisfied that all reasonable alternatives have been considered adequately, the staff is directed to prepare a draft of a final document for consideration by the Board. A vote is taken on the final document, again by written ballot. A simple majority of four votes is required for adoption of a pronouncement.

Statements of Financial Accounting Standards

The final product of most technical projects is a Statement of Financial Accounting Standards (SFAS). Like the Exposure Draft, the Statement sets forth the actual standards, the effective date and method of transition, background information, a brief summary of research done on the project and the basis for the Board's conclusions, including the reasons for rejecting significant alternative solutions. It also identifies members of the Board voting for and against its issuance and includes reasons for any dissents.

Additional Due Process

For major projects, the Board generally goes significantly beyond the core due process described above. Soon after a major project is placed on the Board's technical agenda, a resource group usually is formed, including preparers, auditors, and users of financial information who are knowledgeable about the subject matter. Experts from other disciplines also may be included. Care is taken to ensure that various points of view on the issues involved are represented.

The resource group provides information and practical insights from constituents' perspectives on FASB agenda projects. The FASB staff seeks information from resource group members as needed throughout the life of a project, for example, as it initially identifies issues to be addressed and as it issues and develops its analysis of possible alternative approaches. Resource group members also are asked to perform external review of drafts of Exposure Drafts and final Statements.

During development of a standard, usually prior to issuance of an Exposure Draft, the Board may choose to conduct field visits for the purpose of assessing the costs and benefits or operability of the proposed standard.

During the comment period, the Board also may conduct field tests of the provisions of the Exposure Draft, if necessary.

After the discussion document or an Exposure Draft is issued for public comment, the Board often holds public roundtable meetings with interested constituents. Those meetings provide an opportunity for the Board and staff to ask questions about information and viewpoints offered by constituents who participated in the comment process. Observers are welcome at all roundtable meetings.

Statements of Concepts

In addition to Statements of Financial Accounting Standards, the FASB also issues Statements of Concepts. Statements of Concepts do not establish new standards or require any change in the application of existing accounting principles; instead, they are intended to provide the Board and constituents with a foundation for setting standards and concepts useful as tools for solving problems. The framework defined in the Statements of Concepts helps the Board identify the right questions to ask in structuring technical projects and contributes to a consistent approach over time. Because of their long-range importance, Statements of Concepts are developed under the same extensive due process the FASB follows in developing Statements of Financial Accounting Standards on major topics.

Other Documents

In addition to broad issues of financial accounting and reporting, the Board considers narrower issues related to implementation of existing standards and other problems arising in practice. Depending on their nature, application and implementation problems may be dealt with by the Board in Statements or Interpretations or by the staff in FASB Staff Positions. All of those are subject to discussion at public Board meetings and to exposure for comment.

Emerging Issues Task Force (EITF)

The EITF was formed in 1984 in response to the recommendations of the FASB's task force on timely financial reporting guidance and an FASB Invitation to Comment on those recommendations. EITF members are drawn primarily from public accounting firms but also include representatives of large companies and users of financial statements. The Chief Accountant of the Securities and Exchange Commission attends EITF meetings regularly as an observer with the privilege of the floor. Lawrence W. Smith, FASB Director, Technical Application and Implementation Activities, also serves as Chairman of the EITF.

Composition of the EITF is designed to include persons in a position to be aware of emerging issues before they become widespread and before divergent practices regarding them become entrenched. Therefore, if the group can reach a consensus on an issue, usually that consensus is taken by the FASB as an indication that no Board action is needed. A consensus is defined as an agreement, provided that no more than three of the fourteen voting members object. Consensus positions of the EITF are considered part of GAAP. If consensus is not possible, it may be an indication that action by the FASB is necessary.

The EITF meets at least four times a year. Meetings are open to the public and, generally, are attended by substantial numbers of observers; meetings are also broadcast on the FASB website. Because interest in the EITF is high, the FASB has separate subscription plans for keeping up-to-date on the issues. EITF materials are available free of charge on the FASB website.

Availability of Publications

To encourage public comment, Exposure Drafts and other discussion documents are distributed primarily through the FASB website.

Statements of Standards, Statements of Concepts and Interpretations also are distributed broadly when published through FASB subscription plans and may be purchased separately by placing an order at the FASB website. Those documents are also available free of charge on the FASB website.

The FASB strives to keep the public informed of developments on its projects through a monthly newsletter, *The FASB Report*, and a weekly notice, *Action Alert*, which provides notice of upcoming Board meetings and their agendas with brief summaries of actions taken at previous meetings. *Action Alert* is available by e-mail subscription at the FASB website.

FASB Website

The FASB website includes general information about the Board and its activities, information on upcoming public meetings, announcements of Board actions, summaries and status of all active technical agenda projects, minutes of Board meetings, comment letters, the technical plan for FASB projects, and information about the Financial Accounting Foundation, as well as information on how to order publications online, by phone or mail.

The website can be accessed at www.fasb.org.

The Public Record

Transcripts of public hearings, letters of comment and position papers, research reports and other relevant materials on projects leading to issuance of pronouncements become part of the Board's public record. The public records on all projects are available for inspection in the public reference room at FASB offices in Norwalk, Connecticut. Copies of public records also may be purchased at prices that vary according to the volume of material that has to be copied by accessing the FASB website at www.fasb.org or by contacting Records Retention at (203) 847-0700, ext. 270, for more information.

ADDITIONAL INFORMATION***General Information***

For further information about the FASB, including Board meeting schedules, access the FASB website at www.fasb.org, call or write Financial Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116, telephone (203) 847-0700 or via e-mail at director@fasb.org.

To Order Publications

Statements, Interpretations, Exposure Drafts and other documents published by the FASB may be obtained by placing an order on the FASB website at www.fasb.org or by contacting the FASB Order Department at 1-800-748-0659, weekdays 9:00 a.m. to 5:00 p.m. EST.

Public Roundtable Meetings and Comment Letters

For information about submitting written comments on documents or about public roundtable meetings, access the FASB website at www.fasb.org or contact the FASB Project Administration Department at (203) 847-0700, ext. 389.

Public Reference Room and Files

The FASB maintains a public reference room open during office hours, Monday through Friday. The public reference room contains all FASB publications, comment letters on documents and transcripts of public hearings. Copies of this material may be obtained for a specified charge by accessing the FASB website at www.fasb.org or by contacting Records Retention at (203) 847-0700, ext. 270, for an appointment.

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To order additional copies of *FACTS about FASB* without charge, contact Public Relations at (203) 847-0700, ext. 479, or fax a request to (203) 849-9714.

MEMBERS OF THE FASB

The seven members of the FASB serve full time and are required to sever all connections with the firms or institutions they served prior to joining the Board. While collectively they represent diverse backgrounds, they also must possess "knowledge of accounting, finance and business, and a concern for the public interest in matters of financial accounting and reporting."

Board members are appointed for five-year terms and are eligible for reappointment to one additional five-year term. Expiration dates (at June 30) of current terms are indicated in captions beneath the members' photographs.

Robert H. Herz was appointed FASB Chairman, effective July 1, 2002.

He was a Senior Partner with PricewaterhouseCoopers, its North America Theater Leader of Professional, Technical, Risk & Quality and a member of the firm's Global and U.S. Boards. He also served as a part-time member of the IASC.

He joined Price Waterhouse upon graduating from the University of Manchester in England with a B.A. degree in economics. He later joined Coopers & Lybrand as its Senior Technical Partner and later held a similar position with PricewaterhouseCoopers.

He has authored numerous publications and chaired the AICPA SEC Regulations Committee, the Transnational Auditors Committee of the International Federation of Accountants and was a member of the EITF.

G. Michael Crooch was a Partner with Arthur Andersen and Director of the firm's International Professional Standards Group before joining the FASB on July 1, 2000. Mr. Crooch was the American Institute of Certified Public Accountants' (AICPA) delegate to the International Accounting Standards Committee (IASC) and served on the IASC's Executive Committee. He also served on the Institute's Accounting Standards Executive Committee, including three years as the Committee Chairman. He earned bachelor's and

master's degrees from Oklahoma State University and a Ph.D. from Michigan State University.

Katherine Schipper was appointed to the FASB, effective September 2001. Prior to joining the FASB, she was the L. Palmer Fox Professor of Business Administration at Duke University's Fuqua School of Business. She has served the American Accounting Association (AAA) as President and as Director of Research. She was a member of the FASB's Advisory Council (FASAC) from 1996 to 1999. Ms. Schipper holds a B.A. degree from the University of Dayton and M.B.A., M.A. and Ph.D. degrees from the University of Chicago.

Leslie F. Seidman was named to the FASB, effective July 1, 2003. Prior to joining the Board, she managed her own financial reporting consulting firm. Among the previous posts she held were Vice President at J.P. Morgan & Company, where she was responsible for establishing accounting policies, and Assistant Director of Implementation and Practice Issues at the FASB. She started her career as an auditor at Arthur Young & Company. She earned a B.A. degree from Colgate University and an M.S. degree from New York University.

Donald M. Young was appointed to the Financial Accounting Standards Board (FASB), effective January 1, 2005. Prior to joining the FASB, Mr. Young managed his own firm providing consulting and research services for technology and private equity clients. Previous to that he was Managing Director at PaineWebber/UBS and held senior positions at several investment banking firms. He is a member of CFA Institute. He received a bachelor's degree from the University of Michigan and earned an M.B.A. degree from Harvard Business School.

Edward W. Trott was appointed as a member of the FASB, effective October 1, 1999. Since 1992, he headed the Accounting Group of KPMG's Department of Professional Practice. Before joining the Board, he was a member of the FASB's Emerging Issues Task Force, the Financial Reporting Committee of the Institute of Management Accountants, the FASB's Advisory Council and the Accounting Standards Executive Committee and Auditing Standards Board of the AICPA. He holds a bachelor's degree from the University of North Carolina and an M.B.A. degree from the University of Texas.

George J. Batavick was named a member of the FASB, effective August 1, 2003. He was previously Comptroller of Texaco Inc. where he had company-wide responsibility for strategy and policy matters, covering all aspects of accounting and financial reporting. Prior to this post, he held a number of key positions, including Deputy Comptroller and Director of Internal Auditing. Before joining Texaco, he was with Getty Oil Company. He began his career at Arthur Andersen. He is a graduate of St. Joseph's University in Philadelphia where he earned a B.S. degree.

FASB Staff

The Board is assisted by a staff of approximately 68 professionals drawn from public accounting, industry, academe and government, plus support personnel. The staff works directly with the Board and task forces, conducts research, participates in public hearings, analyzes oral and written comments received from the public and prepares recommendations and drafts of documents for consideration by the Board.

FASB Fellows are an integral part of the research and technical activities staff. The Fellowship program provides the Board the benefit of current experience in industry, academe and public accounting and offers the Fellows first-hand experience in the accounting standard-setting process. Fellows take a leave of absence from their firms or universities and serve as project managers or consultants on a variety of projects.

Suzanne Q. Bielstein is Director, Major Projects and Technical Activities for the FASB. Previously, she served in various capacities at the FASB, including Assistant Director of Technical Research and Project Manager on the business combinations and combinations for not-for-profit organizations. Prior to joining the FASB in early 1999, she spent five years with Caradon plc in two different roles—Vice President of Planning, North America, and Vice President and Corporate Controller of Clarke American Checks, Inc. (a subsidiary of Caradon). Before joining Caradon, Ms. Bielstein was an Audit Partner at KPMG in Boston. Ms. Bielstein earned a B.B.A. degree in accounting from the University of Notre Dame.

Kimberley Ryan Petrone, who has been a member of the FASB staff since 1989, was named Director, Planning, Development and Support Activities in April 2002. Previously, Ms. Petrone was a Project Manager on the Board's business combinations project from 1997 through issuance of Statements 141 and 142 in July 2001 and has been involved in a number of other FASB projects. Before joining the FASB, Ms. Petrone was a Corporate Accounting and Financial Reporting Manager with Savin Corporation. Prior to Savin, she was with AMAX Inc. She earned a B.S. degree in accounting from the University of Bridgeport and an M.B.A. degree from the University of Connecticut.

Lawrence W. Smith was named Director, Technical Application and Implementation Activities of the FASB in August 2002. Prior to assuming this post, he was a Partner with KPMG for 14 years, headquartered most recently in Stamford, Connecticut. From 1992–1996, Mr. Smith served as a Partner in KPMG's Department of Professional Practice in New York. During his 25-year tenure with KPMG, he served as Engagement Partner and SEC Reviewing Partner on a number of international Fortune 1000 clients. He is a past member of the Technical Standards Subcommittee of the Professional Ethics Committee of the AICPA. Mr. Smith received an M.S. degree in accounting from Northeastern University.



**Testimony of
Robert H. Herz
Chairman
Financial Accounting Standards Board
before the
Financial Institutions and Consumer Credit Subcommittee of the
Committee on Financial Services
April 13, 2005**

Attachment 2

Summary of Project on Combinations Between Mutual Enterprises

Combinations Between Mutual Enterprises

Project Summary

Source: <http://www.fasb.org/project/mutuals.shtml>

Last Updated: March 8, 2005 (Updated sections are indicated with an asterisk *)

The staff has prepared this summary of Board decisions for information purposes only. Those Board decisions are tentative and do not change current accounting. Official positions of the FASB are determined only after extensive due process and deliberations.

1. **Objective**
2. ***Immediate Plans**
3. **Summary of Tentative Decisions**
4. **Board Meetings and Other Public Meeting Dates**
5. **History and Background**
6. **Frequently Asked Questions**
7. **Contact Information**

1. OBJECTIVE

This project is another phase of the Board's project on business combinations and is being conducted jointly with the Canadian Accounting Standards Board. The objective of this joint project is to develop guidance on the accounting for combinations between two or more mutual enterprises. The tentative decisions reached in this project will be included in the Exposure Draft for the **Business Combinations: Purchase Methods Procedures project**. This project uses a "differences-based" approach that presumes that the provisions of FASB Statement No. 141, *Business Combinations*, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*, apply to combinations between mutual enterprises, unless conditions of the combination are found to be so different as to warrant a different accounting treatment. The most notable of those differences identified are the lack of equity investors (in the traditional sense) and the lack of a readily identifiable and measurable monetary consideration.

2. *IMMEDIATE PLANS (updated March 8, 2005)

The tentative decisions reached in this project will be included in the Exposure Draft for the **Business Combinations: Purchase Methods Procedures project**. The FASB and the IASB (the "Boards") are developing common Exposure Drafts of their proposed Statements on accounting for business combinations (which for the FASB includes combinations between mutual enterprises). **The Boards expect to issue their Exposure Drafts in the second quarter of 2005.**

Refer to the Business Combinations: Purchase Method Procedures project for additional information.

3. SUMMARY OF TENTATIVE DECISIONS

Refer to the Business Combinations: Purchase Method Procedures project for additional information and the staff draft of the tentative decisions reached through August of 2004.

4. BOARD MEETINGS AND OTHER PUBLIC MEETINGS

Below is a list of the FASB Board meetings for this project. Minutes for meetings beginning with those of the March 17, 2003 meeting are available on the FASB website. They generally are posted within two weeks following the meeting.

- | | |
|-------------------|---|
| January 27, 2004 | Liaison Meeting —To discuss how the Board's decisions on the Combinations Between Mutual Enterprises and the Liabilities and Equity projects would impact mutual enterprises. |
| December 17, 2003 | Board Meeting —Enterprise Measurement, Goodwill for Mutual Enterprises, Transitional Provisions for Mutual Enterprises, Credit Union Core Deposit Intangible Assets, Additional Disclosure for Business Combinations, and Follow-up on Definition of a Business |
| March 17, 2003 | Board Meeting —Issues surrounding the methods used for estimating the fair value of an acquired mutual enterprise |
| September 4, 2002 | Board Meeting—Accounting for the fair value of the acquired mutual enterprise in the acquiring mutual enterprise's financial statements, disclosure, transition, and disposition of Statement 72 and Interpretation 9 insofar as they relate to a combination between mutual enterprises. |
| May 8, 2002 | Board Meeting—Initial measurement of the acquisition cost of an acquired mutual enterprise |
| January 23, 2002 | Board Meeting—Identifying the acquiring mutual enterprise, recognizing identifiable intangible assets |
| December 19, 2001 | Board Meeting—Use of purchase method to account for combinations between mutual enterprises |
| October 29, 2001 | Roundtable Discussion—Mutual enterprises |

5. HISTORY AND BACKGROUND

The effective dates of Statements 141 and 142 were deferred for combinations between two or more mutual enterprises to allow the Board time to consider whether there are any unique attributes of mutual enterprises to justify an accounting treatment different from that provided in those Statements. That means that mutual enterprises will continue to account for business combinations

and acquired intangible assets following the guidance in APB Opinion No. 16, *Business Combinations*, and APB Opinion No. 17, *Intangible Assets*, until a final Statement on combinations of mutual enterprises is issued and effective.

The following were among the reasons why the Board decided to undertake this separate project.

- *There is diversity in current practice.* Some combinations between mutual enterprises have characteristics that distinguish them from other business combinations. For example, some combinations do not include the exchange of cash or other assets as consideration. There are differing interpretations as to how the provisions of Opinion 16 should be applied to combinations of mutual enterprises, particularly those in which there is no exchange of consideration. Those differing interpretations have led to diversity in practice.
- *Guidance is needed due to the proposed elimination of the pooling-of-interests method.* Statement 141 eliminated the pooling-of-interests method (pooling method). In practice today, many combinations of mutual enterprises are accounted for in a manner similar to the pooling method. This project is needed to provide guidance to mutual enterprises in light of the Board's prohibition of the use of that method.

Deliberations on this project were deferred until the Board completed its work on Statements 141 and 142. With the issuance of those Statements, the Board commenced deliberations of the issues in this project, reaching the tentative decisions described above.

6. FREQUENTLY ASKED QUESTIONS

a. What is a Mutual Enterprise?

As defined in the glossary of Statement 141, a mutual enterprise is "(a)n entity other than an investor-owned entity that provides dividends, lower costs, or other economic benefits directly and proportionately to its owners, members, or participants. Mutual insurance companies, credit unions, and farm and rural electric cooperatives are examples of mutual enterprises (FASB Concepts Statement No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, paragraph 7)."

b. Is Statement 141 applicable to the combination of two mutual enterprises? If not, what guidance should be applied?

Paragraph 60 of Statement 141 states that Statement 141 is not effective for combinations *between two or more mutual enterprises* until interpretive guidance is issued. As of this time that guidance has not been issued. Therefore, APB Opinion 16 and related interpretative guidance

(including, but not limited to, FASB Interpretations of Opinion 16 and AICPA Audit and Accounting Guides) should continue to be applied until further guidance is issued. The tentative decisions reached in this project will be included in the Exposure Draft for the *Business Combinations: Purchase Methods Procedures* project, which the Board expects to issue in the second quarter of 2005.

7. CONTACT INFORMATION

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**Testimony of
Robert H. Herz
Chairman
Financial Accounting Standards Board
before the
Financial Institutions and Consumer Credit Subcommittee of the
Committee on Financial Services
April 13, 2005**

Attachment 3

**Summary of Project on Business Combinations: Purchase Method
Procedures (including Combinations Between Mutual Enterprises) and
Certain Issues Related to the Accounting for and Reporting of
Noncontrolling (Minority) Interests**

Business Combinations: Purchase Method Procedures (including Combinations Between Mutual Enterprises) and Certain Issues Related to the Accounting for and Reporting of Noncontrolling (Minority) Interests

Project Summary

Source: http://www.fasb.org/project/bc_purchmethod.shtml

Last Updated: March 24, 2005 (Updated sections are indicated with an asterisk *)

The staff has prepared this summary of Board decisions for information purposes only. Those Board decisions are tentative and do not change current accounting. Official positions of the FASB are determined only after extensive due process and deliberations.

1. Objectives
2. Decisions Reached at the Last Meeting
3. *Immediate Plans
4. Summary of Tentative Decisions
5. Board Meetings/Public Meeting Dates
6. *Related FASB Articles
7. History and Background
8. Contact Information

Note: The Combinations Between Mutual Enterprises (Updated March 8, 2005) portion of this project has a separate project summary.

1. OBJECTIVES

This project is the second phase of the Board's overall project on business combinations. The objectives of the project are to revise the existing guidance related to the application of the purchase method of accounting to (1) improve the transparency of information provided to users of financial statements, (2) improve the internal consistency of the procedures and consistency of that guidance with the conceptual framework, and (3) promote the international convergence of accounting standards by partnering with the IASB on this project. Among the expected benefits are the increased comparability, understandability, and usefulness of reported information and reductions in the cost of preparing information resulting from the elimination of accounting inconsistencies. The following are among the proposals that are expected to result in those benefits:

- a. That all acquisitions of businesses be measured at the fair value of the business acquired.

- b. That substantially all of the assets acquired and liabilities assumed of the acquired business be recognized and measured at their fair values at the acquisition date.
- c. That entities that follow U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations.

The FASB and the IASB (the "Boards") are developing common Exposure Drafts of their proposed Statements on accounting for business combinations (which includes combinations between mutual enterprises). Those Exposure Drafts will incorporate the decisions reached by the Boards' in (1) their joint project on purchase method procedures project (a broad reconsideration of the aspects of the purchase method of accounting that were not deliberated by the FASB in its Statements No. 141, *Business Combinations*, and No. 142, *Goodwill and Other Intangible Assets*) and (2) the Boards' separate business combinations earlier projects, which that led to their separate issuance of Statement 141 and the IASB's IFRS 3, *Business Combinations*. The Boards expect that the standards and implementation guidance in the common Exposure Drafts will differ only in those few instances in which the Boards reached different decisions on the same issue. Details on the IASB's decisions to date are available on their web site www.iasb.org.uk/.

Both this project and the Board's project on **liabilities and equity** include issues related to the accounting for and reporting of noncontrolling (minority) interests. In the fourth quarter of 2002, the Board and the IASB decided to address all those issues concurrently through deliberations led by a single project team (the business combinations team). Certain noncontrolling interest decisions reached affirm or modify tentative conclusions that the Board proposed and exposed for comment in its October 2000 Exposure Draft, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*.

2. DECISIONS REACHED AT THE LAST MEETING

The most recent FASB Board decisions on this project were on:

February 16, 2005 Decisions—Action Alert

3. *IMMEDIATE PLANS (updated March 24, 2005)

The Boards are developing common Exposure Drafts of their proposed Statements on accounting for business combinations (which for the FASB includes combinations between mutual enterprises). The Boards expect that the standards and implementation guidance in the Exposure Drafts will differ only in instances in which the Boards reached different decisions on the same issue.

Issuance of the Exposure Drafts on business combinations purchase method procedures and noncontrolling interests now **are expected in the second quarter of 2005**. That change in timing (from the first quarter of 2005) is a result of the FASB's and IASB's deliberations in the first quarter of 2005 related to converging some of the remaining issues for which the Boards reached differing tentative conclusions (see Drafting Issues in the Summary of Tentative Decisions).

The Board expects to address the comment period for the forthcoming Exposure Drafts for business combinations and noncontrolling interests and the effective dates for these proposed Statements in April 2005.

The FASB plans to have public roundtable meetings with constituents to discuss the proposed Statements; however, the timing of that meeting, which will most likely be near the end of the comment period, has not yet been determined.

4. SUMMARY OF TENTATIVE DECISIONS

Deliberations and Tentative Conclusions for August 2001 through August 2004

The Board substantially completed its deliberations in July 2004. The FASB staff posted staff drafts of FASB Statement 141 (revised) and replacement of ARB No. 51, *Consolidated Financial Statements*, marked to show how each would be amended to reflect the tentative decisions reached by the Board in the purchase method procedures project (including certain issues related to the accounting for and reporting of noncontrolling interests). Those staff drafts reflect the decisions reached in this project through August of 2004. Posting these documents to the website allows FASB constituents the opportunity to study the proposed changes to the accounting for a business combination and noncontrolling interests before the Exposure Draft is issued for public comment.

Tentative decisions reached through August of 2004 follow:

Summary of FASB Tentative Decisions on Business Combinations (including Mutual Enterprises) (156 pages)

Summary of FASB Tentative Decisions on Noncontrolling Interests (67 pages)

Developments Subsequent to August 2004 (updated March 8, 2005)

Field Visits

The Board conducted field visits with eight enterprises (volunteers) that recently completed business combinations with one or more of the following circumstances:

- a. A significant element of contingent consideration (other than stock price)
- b. An acquisition in which control of the business was achieved through a purchase of considerably less than a 100 percent controlling interest or through means other than a purchase
- c. An acquisition of a mutual enterprise (for example, a credit union, mutual bank, or cooperative) through an exchange of member interests.

The Board completed those field visits in early October of 2004. It noted that the field visits provided useful suggestions for clarifying the guidance in the common Exposure Draft. The Board observed that the benefits of the proposed Statement are justified in relation to the incremental costs identified and that the collective information gathered in the field visits does not necessitate changing the fundamental tentative conclusions in the staff draft of the Exposure Draft.

Drafting Issues

In drafting the common business combinations Exposure Draft the staff identified a number of drafting issues, which the Board discussed at its November 24, 2004 and February 16, 2005 meetings. The Board decided to:

Definitions

- Retain the definition of a business combination that it agreed to earlier in this project. (At its December 2004 meeting, the IASB agreed to converge with the FASB's definition of a business combination for the purposes of the Exposure Draft.)
- Adopt the IASB's approach in IFRS 3 and define *goodwill* by its nature rather than by its measurement.

Recognition

- Retain its existing criteria for recognizing intangible assets separately from goodwill.
- Require that any recognition of an acquirer's deferred tax benefits (through the reduction of the acquirer's previously recorded valuation allowance) that results from a business combination be included in income at the acquisition date. Currently, FASB Statement No. 109, *Accounting for Income Taxes*, requires that such deferred tax benefits be recognized through a corresponding reduction of goodwill or certain noncurrent assets or an increase in negative goodwill. The amount of such benefits reported in income should be disclosed in the notes to the financial statements.
- Clarify the subsequent accounting for reacquired rights acquired in a business combination that would be initially accounted for as intangible assets under Statement 142 and the application guidance of EITF Issue 04-1, "Accounting for Preexisting Relationships between the Parties to a Business Combination."

Subsequently, those rights would be amortized over the remaining contractual period of the precombination contract that granted those rights.

Disclosure and Transition

- Adopt the IASB's approach in IFRS 3 and require that any adjustments made to the initial accounting for a business combination be accounted for by restating prior periods.
- Amend the disclosure requirement for the reconciliation of the carrying amount of goodwill in Statement 142 to clarify that the reconciliation should include the items listed in paragraph 75 of IFRS 3.

Other

- Converge the guidance for identifying the acquirer in Statement 141 and IFRS 3. (At its December 2004 meeting, the IASB also agreed to converge this guidance for identifying the acquirer.)
- Include in the common Exposure Draft the reverse acquisition guidance and related example that is currently included in IFRS 3, modified as necessary to conform to the decisions made in this phase of the business combinations project.

5. BOARD MEETINGS/ PUBLIC MEETING DATES

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.

Below is a list of the FASB Board/Public meetings for the past 12 months. Minutes for meetings generally are posted within two weeks following the meeting. Refer to IASB website for IASB Board Meetings.

February 16, 2005	Board Meeting —Resolution of drafting issues identified in developing the common business combinations Exposure Draft.
November 24, 2004	Board Meeting —Drafting issues identified in developing the common business combinations Exposure Draft, summary of field visit observations, and revised issuance date of the common Exposure Draft.
July 27, 2004	Board Meeting —Proposed clarifications to the Board's decision for attributing net income or loss of a partially owned subsidiary and whether that decision should be applied to variable interest entities and (2) report on certain Project Resource Group Members' input on what should be included

	as part of the business combination accounting
June 30, 2004	Board Meeting —Issues identified in drafting the noncontrolling interests' Exposure Draft
June 9, 2004	Board Meeting —Clarification and resolution of issues pertaining to (1) the accounting for equity-based compensation awards exchanged in a business combination, (2) whether the scope of the purchase method procedures project should be expanded to consider the accounting for groups of assets or net assets that do not constitute a business, and (3) the definition of a business and related application guidance.
April 22, 2004	Joint Meeting with the IASB —Purchase method convergence issues.
April 14, 2004	Board Meeting —Clarification and resolution of differing interpretations of the October 2003 FASB-IASB joint decision about which assets and liabilities should be considered part of the business combination accounting and the effective date for the proposed Statements on business combinations and noncontrolling interests.
April 7, 2004	Board Meeting —Interrelation of the business combinations project with (a) the Board's project on equity-based compensation and (b) FASB Interpretation No. 46 (revised December 2003), <i>Consolidation of Variable Interest Entities</i> .
March 24, 2004	Board Meeting —Short-duration insurance contracts and subsequent accounting for assets and liabilities arising from insurance contracts in a business combination
February 25, 2004	Board Meeting —Issues identified in drafting the business combinations Exposure Draft
February 4, 2004	Board Meeting —Definition of a business

6. *RELATED FASB ARTICLES

Download the article, "[Business Combinations—FASB and IASB Joint Project Update](#)" from *The FASB Report*, No. 259, August 31, 2004.

Discussion at the September, 2003 FASAC Meeting

FASB Status Report, "FASB Addresses Purchase Accounting Issues in Joint Project with IASB," Osborne, Michael P., November 30, 2001

7. HISTORY AND BACKGROUND

In August 1996, the Board added to its agenda the project on business combinations to reconsider APB Opinions No. 16, *Business Combinations*, and No. 17, *Intangible Assets*. The first part of that project resulted in the issuance of Statements 141 and 142. In those Statements, the FASB eliminated the use of the

pooling of interests method of accounting for business combinations and also addressed purchase accounting guidelines for acquired intangible assets and goodwill and goodwill impairment. However, the FASB left unchanged most purchase accounting guidance, with the expectation that the guidance would be addressed in this part of the project. In Statement 141, the FASB concluded that the purchase method is the appropriate method of accounting for business combinations; however, the Board recognized that there are shortcomings in the current guidance, including some guidance that is inconsistent with the conceptual framework. Therefore, following the issuance of Statements 141 and 142 (June 2001), the Board commenced deliberations on this part of the project. Other parts of this project are addressing issues related to the accounting for combinations of not-for-profit organizations and the accounting for combinations between mutual enterprises.

8. CONTACT INFORMATION

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**Testimony of
Robert H. Herz
Chairman
Financial Accounting Standards Board
before the
Financial Institutions and Consumer Credit Subcommittee of the
Committee on Financial Services
April 13, 2005**

Attachment 4

"Truth In Testimony" Disclosure Form



STATEMENT
OF
THE HONORABLE JOANN JOHNSON
CHAIRMAN
NATIONAL CREDIT UNION ADMINISTRATION

ON THE
"NET WORTH AMENDMENT FOR CREDIT UNIONS ACT"
H.R. 1042

BEFORE THE
SUBCOMMITTEE
ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
U.S. HOUSE OF REPRESENTATIVES

APRIL 13, 2005

Chairman Bachus, Ranking Member Sanders, and Members of the Subcommittee: I appreciate your invitation to appear here today to speak on behalf of the National Credit Union Administration (NCUA) to support the important legislation you have introduced -- the "Net Worth Amendment For Credits Unions Act."

NCUA anticipates that the Financial Accounting Standards Board (FASB) will act in 2005 to lift the current deferral of the acquisition method of accounting for mergers by credit unions thereby eliminating the pooling method and requiring the acquisition method beginning in 2006.¹ When this change to accounting rules is implemented it will require that, in a merger, the net assets on a fair value basis of the merging credit union as a whole, rather than retained earnings, be carried over as "acquired equity," a term not recognized by the "Federal Credit Union Act" (FCUA).

This FASB policy has been in place since mid-2001 for most business combinations and the delay by FASB in implementing it for credit unions has allowed all of us to explore how credit unions could conform to the new financial reporting standards. H.R. 1042 is a good solution.

Without the changes to the "Federal Credit Union Act" proposed by H.R. 1042, only "retained earnings" of the continuing credit union will count as net worth after a merger. This result would seriously reduce the post-merger net worth ratio of a federally insured credit union, because this ratio is the retained earnings of only the continuing credit union stated as a percentage of the combined assets of the two institutions. A lower net worth ratio has adverse implications under the statutory "prompt corrective action" (PCA) regulation. This result will discourage voluntary mergers and on occasion make NCUA assisted mergers more difficult and costly to the National Credit Union Share Insurance Fund (NCUSIF). Without a remedy, an important NCUA tool for reducing costs and managing the fund in the public interest will be lost.

This agency, and the credit unions we serve, are grateful for the analysis and time you are devoting to this matter and for bringing us quickly to the point of advancing the narrow and specific changes to the "Federal Credit Union Act" needed to preserve credit union capital in mergers that take place after FASB fully implements its policy for credit unions.

¹ Statement of Financial Accounting Standard (SFAS) No. 141, Business Combinations, requiring the acquisition method for business combinations and effectively eliminating the pooling method. The pooling method has typically been used by credit unions to account for credit union mergers. The standards became effective for combinations initiated after June 30, 2001. Paragraph 60 of the standard deferred the effective date for mutual enterprises (i.e., credit unions) until the FASB could develop purchase method procedures for those combinations. In the interim, credit unions have continued to account for mergers as poolings (simple combination of financial statement components).

Preserving “Retained Earnings”- The Only Source of “Net Worth” For Federally Insured Credit Unions

The “Credit Union Membership Access Act of 1998” established a statutory system of prompt corrective action standards for federally insured credit unions. Capital, or the term “net worth” for credit unions, is defined as limited to retained earnings as determined in accordance with generally accepted accounting principles (GAAP).

In the context of credit union mergers, where the “pooling method” of accounting has traditionally been used, the retained earnings of the two credit unions are pooled and the sum of these retained earnings become the net worth of the combined credit union. This logical result facilitates the ability of credit unions to merge when it is in the best interests of their members. It preserves the capital accumulated by both institutions and, importantly, is less likely to place the combined institution into a lower PCA category.

FASB’s proposed change to accounting rules, along with an amendment to the “Federal Credit Union Act” that allows NCUA to recognize “...any amounts that were previously retained earnings of any other credit union...” will produce results consistent with the goal of FASB and comparable to results achieved for other business combinations.

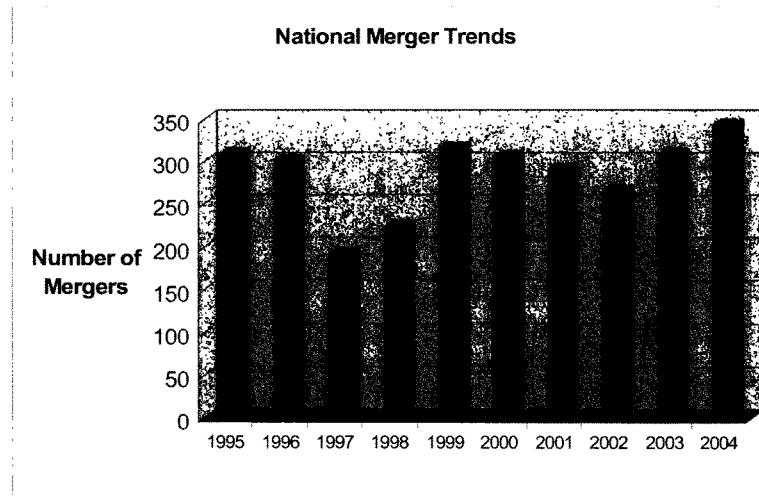
When crafting the PCA provisions of the FCUA in 1998, this policy change by FASB for financial reporting purposes was not anticipated. To explain why a lower net worth ratio has serious adverse implications under PCA, let me summarize the consequences. Under current law an insured credit union is:

- “well capitalized” if it has a net worth ratio of not less than 7%. Falling below 7% triggers an earnings retention requirement and involvement with NCUA that most insured credit unions would like to avoid;
- “adequately capitalized” if it has a net worth ratio of not less than 6%. Falling below 6% requires the credit union to produce a net worth restoration plan and additional regulatory involvement;
- “undercapitalized” if net worth is below 6%. With this status comes restrictions on asset growth and member business loans;
- “significantly undercapitalized” if net worth is less than 4%;
- “critically undercapitalized” if the net worth ratio is less than 2%. Here the NCUA Board has 90-days to take action, such as conserving, liquidating or merging the credit union.

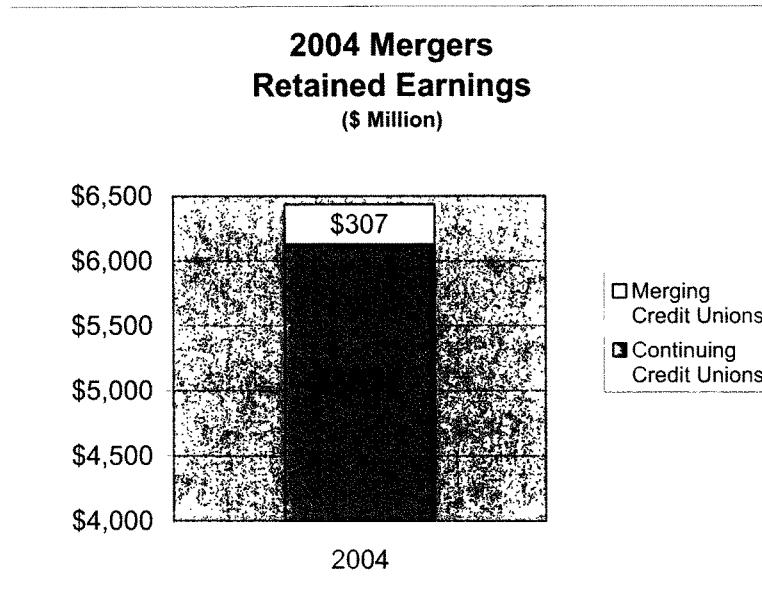
A merger is normally a necessary or beneficial change, but it may cause adverse consequences if the retained earnings of the merged insured credit union are lost -- an unexpected and undesirable consequence for credit unions, their members, FASB and NCUA. The management and board of directors of the continuing

credit union considering a merger will give pause when faced with this result, as will NCUA.

In 2004 there were approximately 338 mergers involving federally insured credit unions. Of those, 237 were voluntary mergers and 7 involved some degree of financial assistance from NCUA. There were 94 mergers in process at year-end.



The number of mergers has been relatively constant for a many of years, so the significance of both the potential problem and the significance of the solution offered by H.R. 1042 is quite real. Without a solution, necessary or beneficial mergers would either be foregone or consummated with a loss of net worth. In the case of assisted mergers, it would be at greater cost to the NCUSIF to make the continuing credit union whole.



The chart above shows if FASB's Statement of Financial Accounting Standard 141 had been applied to federally insured credit unions in 2004 without the statutory adjustment, some \$300 million in credit union capital might have been lost for PCA purposes.

The "Net Worth Amendment For Credit Unions Act" clearly and appropriately preserves the only source of hard-earned credit union capital when mergers of institutions are accomplished – retained earnings.

FDIC insured financial institution's equivalent "leverage ratio" includes virtually all GAAP equity components. Therefore, it is my understanding banks and their insurers do not have the same concerns because their existing capital definition under relevant law is broader. The FASB rule, in combination with their statutory definition of capital, would not cause the same problem for acquiring banks and thrifts because they are allowed to include virtually all components of equity in their capital.

Thank you, Mr. Chairman, for introducing H.R. 1042, holding this hearing today and acting to preserve the capital of federally insured credit unions.



National Association of State Credit Union Supervisors
 NASCUS Credit Union Council
 NASCUS Foundation for the Preservation of Dual Chartering
 National Institute for State Credit Union Examination

**Written Testimony of George Reynolds
 Senior Deputy Commissioner,
 Georgia Department of Banking and Finance
 on behalf of the
 National Association of State Credit Union Supervisors
 Before the
 Subcommittee on Financial Institutions and Consumer Credit
 United States House of Representatives
 April 13, 2005**

NASCUS History and Purpose

Good afternoon, Chairman Bachus, and members of the Subcommittee. I am George Reynolds, Senior Deputy Commissioner for the Georgia Department of Banking and Finance. I appear today on behalf of the National Association of State Credit Union Supervisors (NASCUS), the professional state credit union regulators association. NASCUS represents the 48 state and territorial credit union supervisors, dedicated to defending the dual chartering system for credit unions and advised by the NASCUS Credit Union Council, which is comprised of more than 500 state-chartered credit unions.

In addition to being a state regulator, I am a certified public accountant allowing me to study and understand the accounting standards recommended by the Financial Accounting Standards Board (FASB). Today I have made recommendations on behalf of NASCUS regarding the impact of changes to the accounting standards regarding mutual institutions.

The mission of NASCUS is to enhance state credit union supervision and to advocate policies that ensure a safe and sound state credit union system. We achieve those goals by serving as an advocate for a dual chartering system that recognizes the traditional and essential role that state government plays as a part of the national system of depository financial institutions.

NASCUS applauds the introduction of H.R. 1042, the Net Worth Amendment for Credit Unions Act, which amends the definition of net worth to include the net worth of a credit union merged with a surviving credit union. We appreciate the opportunity to provide the Subcommittee with our comments H.R. 1042, and look forward to the successful passage of this Act.

My testimony today is to urge your support of H.R. 1042. This Act amends the Federal Credit Union Act to clarify the definition of net worth for purposes of prompt corrective action.

As an overview, FASB 141 replaces the pooling method of accounting with the purchase accounting method for mergers of mutual enterprises. Without the proposed statutory amendment, the new accounting methodology does not allow the retained earnings of a merging credit union to be added to the retained earnings of a surviving credit union. Ultimately, safety and soundness is an issue because credit unions are discouraged from mergers, even when their regulator recommends them.

While this bill is extremely brief, I cannot overemphasize the criticality of this change to the safety and soundness of credit unions.

Impact of FASB 141 to the State Credit Union System

The FASB is making changes to the accounting standards for business combinations between mutual enterprises, which includes credit unions. The result of these changes is twofold. First, the pooling accounting method will no longer be an acceptable method for accounting for business combinations. Second, purchase accounting will now be used almost exclusively for business combinations.

The impact of H.R. 1042 would be to revise the definition of net worth to include both the retained earnings of the surviving credit union and any other credit union with which the surviving credit union is combined. This would permit capital to be added in a merger transaction and would serve to augment the capital position of the surviving credit union.

I am unable to provide a detailed explanation of purchase accounting versus pooling accounting in this testimony. I do want, however, to outline the serious unintended consequences of this change if the definition of net worth is not changed, as proposed in the bill.

Without the proposed statutory amendment, a merger transaction between two credit unions would not allow the retained earnings of the merging credit union to be added to the retained earnings of the surviving credit union. This will discourage mergers recommended by state regulators. Mergers are a safety and soundness tool regulators use to protect funds deposited by American consumers and to preserve the National Credit Union Share Insurance Fund.

Our Department and other state departments regularly use mergers to combine weak or troubled financial institutions with larger and stronger financial

institutions, providing a win-win for both American consumers and the insurance fund. Without the ability to combine the capital of the two institutions, in addition to the assets and liabilities acquired on the balance sheet, there would be a serious disincentive to effect such mergers.

This is particularly important in purchase accounting, which provides for reflecting assets and liabilities acquired at their fair market value. Marking the balance sheet to market while not being able to include acquired retained earnings is a recipe for capital dilution. After a merger, such credit unions might find themselves in a prompt corrective action (PCA) category, which requires certain unintended mandatory regulatory actions, which credit unions would obviously wish to avoid.

If a credit union could not be merged due to PCA concerns caused by the inability to add the capital of the merged credit union, then credit unions in a weakened condition would be more likely to face liquidation or requests for NCUA financial assistance in merger transactions. An increase in liquidations would cause greater reputation risk, a severe loss of confidence for the credit union industry, greater losses to the deposit insurance fund and increased costs to the industry and ultimately to consumers.

Additionally, most credit unions have some deposits that exceed the deposit insurance limit and these members could face the prospect of losing these funds in a liquidation. Stated simply, this is a recipe for disaster. I never want the credit unions that I regulate in Georgia, or the credit unions in any other state to be confronted with this possibility.

In addition to problem institutions, sound credit unions have sought merger partners in order to provide for greater efficiencies of scale, management succession and improved member services. We have been in a period of industry consolidation in credit unions during the past several years. Without these changes credit unions that might otherwise be operating in a safe fashion might not be able to execute optimal business decisions, which would benefit the credit union and its members.

Our Department can cite numerous instances where a problem financial institution was merged with a stronger financial institution with no cost to the deposit insurance fund and the taxpayer. These mergers have been seamless to credit union members and in many cases have resulted in improved levels of credit union services to members.

H.R. 1042 addresses the concerns with the current definition of net worth. This makes sound business sense and increases the safety and soundness of the credit union industry.

As an accountant, I understand the accounting profession's desire to promote consistency in the accounting for business combinations of all entities including mutuals. However, I continue to have concerns regarding the appropriateness of certain aspects of purchase accounting for business combinations of credit unions, such as the potential for the creation of goodwill, which I do not believe to be appropriate for mergers of mutually held, non-taxable entities. I do recognize that in spite of my reservations, these changes appear inevitable. The statutory changes presented in H.R. 1042 are needed to make certain that the implementation of purchase accounting does not have an adverse safety and soundness impact upon the credit union industry.

Conclusion

In closing, H.R. 1042 proactively addresses the safety and soundness concerns of state regulators. FASB 141 replaces the pooling method of accounting with purchase accounting for mutual enterprises affecting the way capital is counted on a credit union's balance sheet in a merger transaction. To summarize:

- 1.) H.R. 1042 allows the retained earnings of a merging credit union to be added to the retained earnings of a surviving credit union.
- 2.) H.R. 1042 alleviates a credit union's Prompt Corrective Action (PCA) concerns in a merger transaction.
- 3.) H.R. 1042 alleviates safety and soundness concerns of state regulators. Credit unions are no longer discouraged from mergers when their regulator recommends a merger to address safety and soundness concerns.

Chairman Bachus, on behalf of NASCUS, please accept our appreciation for your foresight and steadfastness in your commitment to introduce and pass eventually H.R. 1042.

This concludes my remarks. NASCUS appreciates the opportunity to testify today. We welcome further participation and dialogue. I will now respond to any questions the Subcommittee may have.

Thank you.



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April 13, 2005

The Honorable Spencer Bachus
 Chairman
 House Financial Services Committee
 Subcommittee on Financial Institutions and Consumer Credit
 U.S. House of Representatives
 Washington, D.C. 20515

Dear Chairman Bachus,

[Handwritten signature of Bill Cheney]

On behalf of the National Association of Federal Credit Unions (NAFCU), the only national trade association exclusively representing the interests of our nation's federal credit unions, I am writing to express our strong support for H.R. 1042, the *Net Worth Amendment For Credit Unions Act*, and to thank you and the Subcommittee's Ranking Member, Congressman Sanders, for the key leadership that both of you are undertaking on this very important issue.

NAFCU has been working with the Financial Accounting Standards Board (FASB) for several years regarding the impact that a proposed change in accounting practices regarding "business combinations" that is scheduled to be issued later this year would have on credit unions. While credit unions currently use the "pooling of interests" method in accounting for credit union mergers, the new rule will require them to use the "purchase method" of accounting. Given the current constraints of the Prompt Corrective Action (PCA) section of the *Federal Credit Union Act (FCUA)*, under the purchase method of accounting a credit union would no longer be permitted to bring over the retained earnings of the acquired institution onto its own balance sheet as "retained earnings." Instead the retained earnings of the acquired institution would be brought onto the balance sheet of the acquiring institution as "acquired equity." It is, however, important to note that "acquired equity" is net worth according to generally accepted accounting principles (GAAP) - in the same way that retained earnings are acquired equity. The difference is that under the PCA section of the *FCUA*, the equity would not have been "retained" by the acquiring credit union. Instead, it would be "acquired" by the acquiring credit union, after having been "retained" by the acquired credit union. Since, however, the PCA section of the *FCUA* explicitly defines net worth as GAAP retained earnings, the change to the purchase method of accounting will exclude from net worth a portion of GAAP net worth in post-merger credit unions.

NAFCU and others in the credit union community have raised this concern with officials of FASB and have been advised that FASB will not permit any accounting exceptions from the proposed accounting standard for credit unions. Nevertheless, FASB communicated to NAFCU in an April 27, 2004 letter that they recognize this is an issue that needs timely resolution and that FASB has no difficulty with an amendment to change the definition of net worth under the PCA section of the *FCUA* to address this issue. This letter was introduced into the record by NAFCU's witness, Bill Cheney, at a hearing dealing with "Credit Union Regulatory Improvements" held by your

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Subcommittee on July 20, 2004 and NAFCU wants to thank you and your staff for working with us to get this important piece of legislation introduced.

Unlike other federal financial regulatory agencies, the National Credit Union Administration (“NCUA”) does not have the statutory discretion to define the term “net worth” for the institutions it regulates. When Congress passed the *Credit Union Membership Access Act* in 1998, that added a PCA section to the *FCUA*, it defined the term “net worth” for federally-insured credit unions as “GAAP retained earnings.” It would, therefore, take Congressional action to change that definition. The *Net Worth Amendment for Credit Unions Act* (H.R. 1042) would modify the definition of “net worth,” but would not in any way challenge the FASB’s authority to establish definitive accounting practices and standards.

It is also important to note that H.R. 1042 does not legislate accounting practices; credit unions will be required to use the “purchase method” of accounting for mergers to receive a clean audit. In addition, we would note that this amendment does not grant credit unions that currently lack the authority to offer alternative capital accounts the authority to do so, and it does not confer upon NCUA the regulatory authority or discretion to authorize such accounts now or in the future. Simply stated, this amendment is intended to address a narrow and technical accounting issue and in the process simply maintain the status quo so that, in the case of merging credit unions, $2 + 2$ can continue to equal 4.

Under the “pooling of interests” method of accounting, if a credit union with \$2 million in retained earnings merges with another credit union with \$2 million in retained earnings, the surviving credit union has \$4 million in retained earnings: $2 + 2 = 4$. In the absence of this amendment, when the “purchase method” of accounting becomes mandatory for credit union mergers, if a credit union with \$2 million in retained earnings merges with another credit union with \$2 million in retained earnings, the surviving credit union will only have \$2 million in retained earnings: $2 + 2 = 2$! That inequitable conclusion results from the fact that the *FCUA* defines the “net worth” of a federally-insured credit union as “GAAP retained earnings” and under GAAP when utilizing the “purchase method” of accounting only \$2 million would be categorized as “retained earnings” while the other \$2 million would be classified as “acquired equity.”

Take, for example, the merger of two “well capitalized” credit unions as outlined below:

Credit Union “A” merges into Credit Union “B.” Each has assets of \$10 million, retained earnings of \$1 million and a net worth ratio of 10% (far above the “well capitalized” level of 7%).

Pooling Method – All retained earnings are combined and count as net worth.

The surviving Credit Union “B” now has assets of \$20 million, retained earnings \$2 million and a net worth ratio of 10%. The credit union remains classified as “well capitalized.”

Purchase Method – Current Definition of Net Worth, CU “A’s” Retained Earnings are called Acquired Equity from CU “A” and do not count as net worth.

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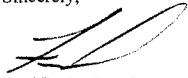
The surviving Credit Union "B" now has assets of \$20 million, retained earnings of \$1 million and acquired equity from CU "A" of \$1 million, resulting in a net worth ratio of 5%. Rather than being classified as "well capitalized" it must be downgraded and classified as "undercapitalized."

Since many credit union mergers are done at the request of the NCUA - as a way of dealing constructively with troubled institutions for purposes of safety and soundness - it is in the public interest to redefine the term "net worth" for PCA purposes so that a credit union is not unfairly penalized and its net worth is not diminished merely because of an antiquated definition contained in the *FCUA*. Otherwise, there will be disincentive in the future for a healthy credit union to merge with a troubled institution at NCUA's request, thereby inhibiting NCUA from dealing in a productive manner with troubled institutions and hindering the members of the troubled institution from continuing to receive credit union services.

It is with this in mind that NAFCU strongly supports H.R. 1042 and urges the Subcommittee to move swiftly and the Congress to expeditiously pass this important legislation.

We thank you and your many colleagues who are co-sponsors of this legislation for your key leadership and we very much look forward to working with you and your staff as this legislation moves forward. If I or the staff at NAFCU may provide you with any further information or be of assistance in any way, please do not hesitate to contact me or our Director of Legislative Affairs Brad Thaler at (703) 522-4770, ext. 204.

Sincerely,



Fred R. Becker, Jr.
President and CEO

FRB/mp

cc: Rep. Bernie Sanders
Members of the Subcommittee

